STUDY

Requested by the ECON Committee

The current Implementation of the Sustainability-related Financial Disclosures Regulation (SFDR)

With an assessment on how the legislative framework is working for retail investors

Policy Department for Economic, Scientific and Quality of Life Policies
Directorate-General for Internal Policies
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The current Implementation of the Sustainability-related Financial Disclosures Regulation (SFDR)

With an assessment on how the legislative framework is working for retail investors

Abstract

The Sustainability-Related Financial Disclosures Regulation (SFDR) is the centrepiece of the sustainable finance strategy for funds and other financial products. However, its provisions are too complex, do not work as intended, and interact insufficiently with provisions shaping corporate reporting, indexes, or client preferences. A revised SFRD should include more recognisable product labels or categories, enable and foster transition investments, smoothly interact with corporate reporting, and expand the scope of disclosure obligations.

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LIST OF ABBREVIATIONS

AIF	Alternative Investment Funds
AIFMD	Alternative Investment Funds Managers Directive
CapEx	Capital Expenditures
CDR	Commission Delegated Regulation
CfE	Call for Evidence
CA	Competent Authority
CRD	Capital Requirements Directive
CSA	Common Supervisory Action
CSDDD	Corporate Sustainability Due Diligence Directive
CSRD	Corporate Sustainability Reporting Directive
CTB	Climate Transition Benchmark
DNSH	Do not significant harm
E/S	Environmental or Social
EBA	European Banking Authority
EIOPA	European Insurance and Occupational Pensions Authority
ELTIFS	European Long-Term Investment Funds
ESAP	European Single Data Point
ESAs	European Supervisory Authorities
ESG	Environmental, Social, and Governance
ESMA	European Securities and Markets Authority
EU	European Union
EuSEF	European Social Entrepreneurship Funds
FA	Financial Advisor
FCA	Financial Conduct Authority
FMP	Financial Market Participant
FF.RR.	Fundamental Rights
GAR	Green Asset Ratio

GHG	Greenhouse Gases
GIIN	Global Impact Investing Network
IBIPs	Insurance-Based Investment Products
ITF	Impact Taskforce Typology
IDD	Insurance Distribution Directive
IORPs	Institutions for Occupational Retirement Provision
IWAI	Impact-Weighted Accounts Initiative
KID	Key Information Document
KPIs	Key Performance Indicators
LGD	Loss-Given Default
MiFID	Markets In Financial Instruments Directive
ML	Machine Learning
MNEs	Multinational Enterprises
MOPs	Multi-Option Products
NCA	National Competent Authority
NFI	Non-Financial Information
NFRD	Non-Financial Reporting Directive
NGO	Non-governmental Organisation
NLP	Natural Language Processing
PD	Probability of Default
OECD	Organisation for Economic Cooperation and Development
OpEx	Operating Expenditures
PAB	Paris-aligned Benchmarks
PAI	Principal Adverse Impact
PEPPS	Pan-European Personal Pension Products
PEPPs	Pan-European Pension Products
PRI	Principles for Responsible Investment
RTS	Regulatory Technical Standards

SDGs	Sustainable and Development Goals
SEC	Securities and Exchange Commission
SFDR	Regulation (EU) 2019/2088 of 27 November 2019 on sustainability-related disclosures in the financial services sector
SHRD	Shareholders Directive
SMSG	Securities Markets Stakeholders' Group
TR	Taxonomy regulation (Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020)
UCITS	Undertakings for the Collective Investment in Transferable Securities
UN	United Nations

EXECUTIVE SUMMARY

Background

The Regulation (EU) 2019/2088 of 27 November 2019 on sustainability-related disclosures in the financial services sector (SFDR) began applying on 10 March 2021 and it was subsequently complemented by a Level 2 Commission Delegated Regulation (CDR 2022/1288) applicable since January 2023, and itself amended by CDR 2023/363. Ever since, it has been the reference legal text for asset managers, financial advisers (FAs) and institutional investors, when determining the sustainability-related disclosures, at product-level and entity-level. The SFDR lays down harmonised rules for financial market participants (FMPs) and FAs on transparency with regard to the integration of sustainability risks, the consideration of adverse sustainability impacts in their investment decision-making and advisory processes, and the disclosure of sustainable investment objectives or the promotion of environmental or social characteristics with respect to financial products.

The SFDR provides disclosure rules. These apply in addition to other disclosure rules (both general, for corporates, and sectoral, for financial intermediaries). It does not formally introduce conduct obligations regarding the consideration of sustainability risks or material adverse impacts on sustainability factors. All in all, considering that the Commission had no models or blueprints, the result was impressive, and the time to create it from scratch even more so. However, soon after it began its operation, the Commission observed that the SFDR was not entirely working as intended, and it launched a comprehensive (re)assessment of SFDR, including a public consultation and a targeted consultation in 2023. Based on this consultation process, a legislative proposal from the Commission to amend the SFDR is expected shortly after the next European Commission begins its term.

Aim

The purpose of this study is to inform the policy debate on sustainability disclosures under the SFDR and provide a legal assessment on possible changes to be brought to relevant legislation in order to improve the framework.

Considering this general purpose, the study has the following goals:

(1) To assess in a legal analysis:

- how and to what extent SFDR provisions can be deemed to ensure the quality and pertinence of information on a financial product's level of sustainability, especially for retail investors;
- how and to what extent SFDR provisions can be deemed effective in increasing investments in financial products supporting sustainability;
- whether (and, if so, how) the SFDR can be adjusted to better accommodate the recent pivot towards transition finance; and,

(2) To propose possible ways to improve the SFDR and align it better with its stated goals.

Key Findings

Any reform of the SFDR needs to start by asking three questions: one, who uses the SFDR information; two, for what purpose; three, what is the goal of the SFDR itself. Starting with the first two, the information generated by the SFDR can have different addressees. This also means that different types of information may feed into different processes and dynamics:

1) investors, especially retail ones, find product information to be useful; in particular, they may primarily be interested in actionable, easy-to-operate classifications, which enable their decisions to invest or divest. Clarity and precision, as well as top-down streamlining

of the information pipeline, is a priority. On the contrary, sophisticated investors may be interested in more complex and granular information;

2) other stakeholders like workers, Non-governmental Organisations (NGOs) and other societal actors may find uses for some information produced under the SFDR, such as Principal Adverse Impact (PAIs), at product or entity level, to raise questions and engage in dialogue with FMPs and FAs;

3) finally, information about risks (also about PAIs) can be useful for supervisory authorities, which may use it to map risks, and spot inconsistencies between the FMPs claims at a product and entity level. Authorities may be interested on two levels of the information: the simpler information may be used to penalise unsubstantiated (greenwashing) claims, while the more complex information may be used to assess and map risks and anticipate potential problems.

As to the goals of the norm itself, the SFDR is currently a "catering" text, which accommodates fixed investor preferences. It may evolve into a more "transformational" text, which seeks to (gently) nudge the market towards sustainability. Or it can try to be both: some provisions would ensure that investors receive clear information about products and their characteristics, while others would facilitate engagement by stakeholders, as well as risk mapping and enforcement by supervisors. In any event, any reform should prioritise clarity and usability of information by investors and other relevant actors.

Investors, especially retail investors, have little use for most of the information generated under the SFDR. Its disclosures are complex and based on concepts that are unfamiliar and unintuitive for investors, such as PAIs, sustainability risks, "taxonomy aligned", "sustainable characteristics", or "sustainable objectives". Investors will be unable to differentiate the types of funds within Article 8 or Article 9 and may even struggle to differentiate Article 8 and Article 9 products. However, even if rules are complex and market actors are not always prepared to apply them, such actors adapt their behaviour in response to the rules when the general message, i.e., the importance to minimise sustainability risks, consider PAIs, or market products with sustainability features, is clear.

On product-level disclosures, the SFDR was conceived as a disclosure regime, but in practice it is used instead as a labelling scheme for "dark green" and "light green" products, yet with no binding threshold to substantiate "greenness" claims. This leads to uncertainty and makes it hard for investors to assess the veracity of green claims. That, in turn, increases the risk of "greenwashing" and mis-selling, but also of "green bleaching", i.e., when FMPs choose not to claim environmental, social, and governance (ESG) features for their products to avoid extra costs and legal risks, and whereas greenwashing is definitely worrying, as it undermines trust in the system, green bleaching may be even more widespread.

Product names, categories or "labels" are useful, though. However, "light green - Article 8" and "dark green - Article 9" should not be transformed into categories. They are too complex and unintuitive for investors. Instead, a new system, with new categories should be established, as already suggested by the Commission in its consultation. In light of investor preferences, market structure, and policy priorities, the new categories should include "impact" products and "transition" (in the sense of transition facilitating) products. The inclusion of "transition" products would make it possible for investors to choose products that, while not making investments that are sustainable, have a clear aim to bring measurable improvements to the sustainability profile of the assets invested in. Indeed, even if mobilising capital for transition finance is a goal of the European Union's (EU) sustainable finance framework, the SFDR does not presently provide the means to do so. A "sustainable" products category, though promising would need more precision.

Clearer product categories would make the information more usable for investors, helping with both "greenwashing" and "green bleaching", under certain conditions. First, all these categories should be based on consumer testing, both beforehand and *ex post,* to ensure that the categories work as intended. Second, products "names" need to be considered together with mechanisms that ensure measurability and accountability. Third, there should be more emphasis on market analysis, to ensure

that the categories encompass a sufficiently large part of the market, and to track whether they help FMPs improve their sustainability features. Studies show that Article 8 and 9 funds saw positive net inflows compared with less sustainable EU funds. There is also evidence that at least some financial intermediaries have changed some features, e.g., carbon intensity in their portfolios. However, evidence is still limited, and authorities should ramp up efforts to better track market trends.

The SFDR also has a fraught relationship with other legal norms in the sustainability disclosure infrastructure. There are inconsistencies with the Taxonomy Regulation, starting with the very concept of “sustainable investment”, and with the Benchmarks Regulation exclusions, and their relationship with the SFDR’s PAIs. There are also problems with corporate reporting under the Corporate Sustainability Reporting Directive (CSRD): corporates and FMPs may differ about what “material” impacts must be reported, and corporates who struggle to comply with all the CSRD data points may have little incentive to produce information in a form and level of detail enough to let FMPs to comply with their own SFDR-based reporting. In general, the information pipeline (including corporate reporting under the CSRD, indexes under the Benchmarks Regulation, and reporting under the SFDR) needs to be streamlined. At the same time, the new SFDR should also include a mandatory disclosure regime of “adverse impact” and cover more products.

The streamlining of rules, and the expansion of their scope, would derive considerable benefit from more emphasis, in parallel, on FMPs’ methodologies, technology and tools to process the information. Authorities that play a constructive role in developing such methodologies and tools may be more prescriptive in their expectations, while reducing (some) FMPs’ dependence on “infomediaries”, regulated (index and ESG Ratings providers) or not (e.g., other data providers).

In conclusion, an SFDR reform seems necessary. First, current provisions should turn into actual “labels”, supported by consumer testing and market analysis. Second, SFDR disclosures should work seamlessly with other disclosure rules. Third, more widespread reporting of PAIs is needed, but calibrated between sustainable or impact products, transition products, and general products with no sustainability features. Fourth, all of this may be possible if an adequate information infrastructure, methodologies and technological tools are developed. This calls for a proactive approach by the authorities, and for flexibility of implementation. Taken together, this would incentivise the offer of such products in the EU.

1. A SHORT INTRODUCTION ON THE SCOPE OF THE STUDY, PRESENTING THE RESEARCH QUESTIONS

The Regulation (EU) 2019/2088 of 27 November 2019 on sustainability-related disclosures in the financial services sector (SFDR)[1], is one of the earliest outputs resulting from the European Commission's Sustainable Finance Action Plan[2], and began applying on 10 March 2021. It was subsequently complemented by a Level 2 Commission Delegated Regulation (CDR 2022/1288)[3] applicable since January 2023, and itself amended by CDR 2023/363.[4] Ever since, it has been the reference legal text for asset managers, financial advisors and institutional investors, when determining the sustainability-related disclosures, at product-level and entity-level.

All in all, considering that the Commission had no models or blueprints, the result was impressive, and the time to create it even more so. However, several years after it began its operation, the Commission observed that the SFDR was not entirely working as intended; in particular that, although it was conceived as a disclosure regime, it was often being used in practice as a "labelling" scheme for "dark green" and "light green" products, yet without any binding threshold to substantiate the "greenness" claims, leading to uncertainty, and difficulty for investors to assess the veracity of the green claims, increasing the risk of "greenwashing" and mis-selling.[5] In addition, the Commission perceived that the SFDR's interaction with other pieces of legislation was not ideal.

Based on this, the Commission launched a comprehensive (re)assessment of the SFDR, including a public consultation[6], and a targeted consultation in September 2023[7]. Based on this consultation process, a legislative proposal from the Commission to amend the SFDR is expected shortly after the beginning of the term of the next European Commission.

Thus, two years from its full entry into force and after the results of the public and targeted consultation processes launched by the European Commission, it is time to verify whether the SFDR transparency legal framework has proven to be functional for achieving its objectives, i.e. harmonising disclosure to end investors on the integration of sustainability risks and on the consideration of adverse sustainability impacts[8], and reduce information asymmetries in the relationship between end

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[1] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector, OJ L 317, 9.12.2019, p. 1–16.

[2] Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions. Action Plan: Financing Sustainable Growth. COM/2018/097 final. The SFDR is contemplated as part of Action 7 (Clarifying institutional investors and asset managers' duties).

[3] Commission Delegated Regulation (EU) 2022/1288 of 6 April 2022 supplementing Regulation (EU) 2019/2088 of the European Parliament and of the Council with regard to regulatory technical standards specifying the details of the content and presentation of the information in relation to the principle of 'do no significant harm', specifying the content, methodologies and presentation of information in relation to sustainability indicators and adverse sustainability impacts, and the content and presentation of the information in relation to the promotion of environmental or social characteristics and sustainable investment objectives in pre-contractual documents, on websites and in periodic reports (hereafter: CDR 2022/1288).

[4] Commission Delegated Regulation (EU) 2023/363 of 31 October 2022, amending and correcting the regulatory technical standards laid down in Delegated Regulation(EU) 2022/1288 as regards the content and presentation of information in relation to disclosures in pre-contractual documents and periodic reports for financial products investing in environmentally sustainable economic activities which started applying in 20 February 2023 incorporated the changes operated by the Climate Delegated Act (CDA 2022/1214). This modified the additional detail to be provided in pre-contractual disclosures, websites and periodic reports on the exposures to Taxonomy-aligned investments in fossil gas and nuclear activities.

[5] "The Sustainability Finance Disclosure Regulation - what next?" Opening remarks by Commissioner McGuinness at DG FISMA event. 10 October 2023. Available at: https://ec.europa.eu/commission/presscorner/detail/en/SPEECH_23_4863.

[6] Commission Consultation Document. Implementation of the Sustainable Finance Disclosures Regulation (SFDR). 15 September 2023. Available at: https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13961-Sustainable-Finance-Disclosure-Regulation-assessment/F_en.

[7] Commission Targeted Consultation Document. Implementation of the Sustainable Finance Disclosures Regulation (SFDR). 15 September 2023. Available at: https://finance.ec.europa.eu/regulation-and-supervision/consultations/finance-2023-sfdr-implementation_en.

[8] Recital 5 SFDR.

investors, on the one hand, and financial market participants (FMPs) and financial advisors (FAs), on the other[9].

Furthermore, the SFDR fits into the broader regulatory framework of the European Commission's 'Strategy for Financing the Transition to a Sustainable Economy'[10] , which aims to channel capital market resources into economic activities capable of ensuring the environmental and climate transition of the real economy. That broader framework has been enriched by several legislation imposing transparency duties related to sustainability impacts – from the Taxonomy Regulation, the Corporate Sustainability Reporting Directive (CSRD), the Benchmarks Regulation to the most recently adopted Corporate Sustainability Due Diligence Directive (CSDDD) – as well as sectoral regulations (Markets in Financial Instruments Directive (MiFID), Insurance Distribution Directive (IDD), etc.). Thus, it is necessary to also examine the coordination between these provisions, and their potential inconsistencies.

Finally, there are broader policy considerations at stake, such as, e.g., whether there is a need to create a level playing field by extending sustainability reporting to all relevant entities and financial products, rather than making it voluntary, or whether, on the contrary, a mandatory regime would disadvantage certain types of investments. It is also necessary to analyse whether the Regulation creates excessive implementation costs for the financial services industry offering sustainable products, which could discourage the development of sustainable and transitional finance and/or stifle innovation in sustainable financial services.

The purpose of this study is to inform the policy debate on sustainability disclosures under the SFDR and provide a legal assessment on possible changes to be brought to relevant legislation in order to improve the framework, including by examining possible options for the co-legislators.

Considering this general purpose, the study has the following goals:

(1) To assess in a legal analysis which would then need to be complemented through a proper market analysis which remains outside the scope of our mandate:

- how and to what extent SFDR provisions can be deemed to ensure the quality and pertinence of information on a financial product's level of sustainability, especially for retail investors;
- how and to what extent SFDR provisions can be deemed effective in increasing investments in financial products supporting sustainability;
- its implications for transition finance; and,

(2) To propose possible ways to improve the SFDR and align it better with its stated goals.

The study offers a legal analysis and has taken into account the developments in this field, including the relevant normative texts (SFDR Level 1 and 2, and other texts, part of the European sustainable finance framework), relevant literature, and the works by the Commission, including the summary report of the Responses to the Consultation, as well as by the European Supervisory Authorities (ESAs) on this and related aspects.

[9] Recital 10 SFDR.

[10] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, 'Strategy for Financing the Transition to a Sustainable Economy', 6 July 2021, COM(2021) 390 final.

2. THE SFDR: OBJECTIVES, SCOPE, MAIN PROVISIONS AND ITS PLACE IN THE INFORMATION INFRASTRUCTURE; THE PIVOT TOWARDS TRANSITION FINANCE

This section provides an introduction to the SFDR objectives and scope (2.1.), its main provisions (2.2.) its place in the information infrastructure and its interplay with rules on information supply (2.3.) and demand (2.4.) and the questions raised by the recent pivot towards transition finance (2.5.)

2.1. The SFDR objectives, scope, and early adoption

The Recitals in the SFDR follow a clear sequence: frame the discussion amidst United Nations (UN) Sustainable Development Goals (SDGs) and Commission and Council statements in that regard (Recital (1)), refer specifically to climate change and the Paris Agreement (Recitals (2) and (3)), mention the harmonised rules on investment funds, including Undertakings for the Collective Investment in Transferable Securities (UCITS), Alternative Investment Funds Managers Directive (AIFMD), European Long-Term Investment Funds (ELTIFS), Institutions for Occupational Retirement Provision (IORPs), European Social Entrepreneurship Funds (EuSEF) and Pan-European Personal Pension Products (PEPPs) (Recital (4)) and then, zoom into the problem, which, according to Recital (5), was (emphasis added) that:

> (5) Disclosures to end investors on the integration of sustainability risks, on the consideration of adverse sustainability impacts, on sustainable investment objectives, or on the promotion of environmental or social characteristics, in investment decision-making and in advisory processes, are insufficiently developed because such disclosures are not yet subject to harmonised requirements.

Thus, the basis for the regulation, according to the co-legislators, are “disclosures”, and the problem has a three-pronged nature: (1) integration of sustainability risks (including, as seen in the SFDR their impact on remuneration), (2) consideration of adverse sustainability impacts, and (3) sustainable investment objectives or the promotion of environmental or social characteristics, all in investment decision-making and advisory processes. All three aspects are, according to the legislators, relevant for end investors.

This three-pronged view is reiterated in Article 1 SFDR, which also addresses its *scope* of application (emphasis added):

> This Regulation lays down harmonised rules for financial market participants and financial advisers on transparency with regard to the integration of sustainability risks and the consideration of adverse sustainability impacts in their processes and the provision of sustainability-related information with respect to financial products.

Apart from repeating the sequence of objectives of “risk”, “adverse impacts”, and “financial product information”, Article 1 also delineates:

> The *subjective* scope of application, i.e., “financial market participants” (FMPs) and “financial advisers” (FAs) as the addressees of its provisions, the former including all kinds

of financial institutions that provide portfolio management and fund management services,[11] or financial advice;[12] and

The *objective* scope of application, i.e., "financial products", which are defined as portfolios that are subject to management under MiFID, alternative investment funds (AIF), insurance-based investment products (IBIPs), pension products, pension schemes, UCITS or pan-European pension products (PEPPs).[13]

Thus, the SFDR is **a cross-cutting text, which tackles the crucial node of fund managers and financial advisers**. This is the node investors normally rely upon to gather their information from the market, since they normally invest not in single financial instruments, but generally in portfolios of those instruments, individually or collectively. By ensuring that the managers and advisers integrate sustainability-related information, legislators ensure that investors have such information at their disposal, such as on sustainability risks, adverse impacts, and products.

Apart from cross-cutting and centered on investment management and advice, the SFDR is also an early legal text. The Commission's Sustainable Finance strategy was adopted in 2018, and the SFDR in 2019. This meant that the SFDR required FMPs and FAs to report sustainability-related information (risks, adverse impacts, objectives) without a more general definition of "sustainable investments", since the Taxonomy Regulation (TR) was adopted in 2020, and it only covers *environmentally* sustainable investments,[14] while the "social" taxonomy is yet to be adopted. Thus, the SFDR had to adopt its own definition of "sustainable investments" encompassing both an "environmental" and a "social" dimension, which would predate the definition in the TR. A comparison between the two shows alignment in principle, but also some differences (emphasis added).

[11] Article 2 (1) (1) (a) – (j) SFDR.

[12] Article 2 (1) (11) (a) – (f) SFDR.

[13] Article 2 (1) (12) (a) – (g) SFDR.

[14] Regulation 2020/852 of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation 2019/2088 (hereafter: TR).

Table 1: The Concept of Sustainable Investment

Article 2 (1) (17) SFDR	Article 3 TR
sustainable investment' means an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance;	For the purposes of establishing the degree to which an investment is environmentally sustainable, an economic activity shall qualify as environmentally sustainable where that economic activity: a) contributes substantially to one or more of the environmental objectives set out in Article 9 in accordance with Articles 10 to 16; b) does not significantly harm any of the environmental objectives set out in Article 9 in accordance with Article 17; c) is carried out in compliance with the minimum safeguards laid down in Article 18; and, d) complies with technical screening criteria that have been established by the Commission in accordance with Article 10 (3), 11(3), 12(2), 13(2), 14(2) or 15(2).
Requirements 1. Contribution to an environmental or social objective. 2. Do not significant harm to environmental or social objective. 3. Good governance practices in investee companies.	Requirements 1. Substantial contribution to environmental objective. 2. Do not significant harm to environmental objective. 3. Respect of minimum safeguards. 4. Compliance with technical screening criteria.

Source: Authors' own elaboration.

A comparison between the two concepts shows that the TR is more focused on environmental criteria, and thus includes more detailed requirements, while the SFDR concept is broader, and, e.g., does not involve "technical screening criteria". Conversely, since the SFDR considers both environmental and social criteria, an investment cannot be "sustainable" under the SFDR if it promotes environmental objectives while harming social objectives, or vice-versa, or if the investee company has poor governance practices. The TR ensures that this does not happen via the requirement of "minimum safeguards".

In addition to the need to define "sustainable investments", its early adoption would also mean that the SFDR would require FMPs and FAs to report on sustainability risks or principal adverse impacts (PAIs)[15] and objectives without an adequate system of (corporate) sustainability reporting in the investee companies to support this. Such system would come later with the Corporate Sustainability

[15] See infra 3.1. for an analysis of these concepts.

reporting Directive (CSRD)[16]. Finally, the SFDR early adoption would require FMPs and FAs to report o sustainability risks, impacts and objectives, after its entry into force, in March 2021[17], while the Commission Level 2 text, Commission Delegated Regulation 2022/1288 (CDR 2022/1288), which included the templates for disclosure, would be applied as of January 2023 (and was modified by CDR 2023/363, applicable since February 2023)[18], a relatively long gap.

2.2. The SFDR main disclosure provisions

The SFDR disclosure regime encompasses:

- In terms of the *substance* of the information: sustainability risks (and remuneration), PAIs and product information.
- In terms of the medium of the information: pre-contractual information, website or periodic reports.

The breakdown of the information is summarised in the following tables.

Table 2: SFDR entity-level disclosures

Entity-level disclosures	
Risks & policies (Website)	Policies on integration of sustainability risks in investment decision-making process, or investment advice (Article 3)
PAIs (Website)	a) If they consider investment decisions PAIs on sustainability factors: statement on due diligence policies for PAIs; or b) If they do not consider PAIs on sustainability factors: clear reasons for why not, including whether/when they will. (Article 4 SFDR, Articles 4-13 and Table 1 Annex 1 CDR 2022/1288) (comply-or-explain, save for large FMPs)
Remuneration Policies and risk (Website)	How remuneration policies are consistent with integration of sustainability risks (Article 5)

Source: Authors' own elaboration.

[16] Directive 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting (Directive 2022/2464 will hereafter be referred to as CSRD, and Directive 2013/34/EU as the Accounting Directive).

[17] Article 20 (2) SFDR.

[18] Article 68 CDR 2022/1288.

Table 3: SFDR product-level disclosures

Product-level disclosures			
	All products (Article 6, general provision)	Products promoting environmental or social (E/S) characteristics ("light green") (Article 8 SFDR)	Sustainable investment as an objective ("dark green") (Article 9 SFDR)
Pre-contractual (Arts. 6, 8, 9)	Integration of sustainability risks in investment decisions. Assessment of likely impact of sustainability risks on financial products return.	Indication that it does not promote sustainable objective. Indication of E/S characteristics promoted. Indication of how characteristics are met. If an index is used, why it is consistent with characteristics. Information on proportion of Asset allocation information, plus "do not significant harm" statement (Article 6 Taxonomy Regulation).	Information on how objective is to be attained. If index used as reference benchmark, information on how it is aligned with objective and how it differs from road market index. Information on methodologies of benchmarks and benchmarks can be found. Asset allocation information (Article 5 Taxonomy Regulation).
Website (Art. 10)		a) Description of E/S characteristics or the sustainable investment objective; b) Information on methodologies to assess, measure and monitor E/S characteristics or impact sustainable investments (data sources, screening criteria for the underlying assets and the relevant sustainability indicators used to measure E/S characteristics or impact); c) Precontractual information; d) Information in periodic reports.	
Periodic Reports (Art. 11)		The extent to which E/S characteristics are met. Taxonomy Regulation information (Article 6).	a) overall sustainability-related impact of product under sustainability indicators; or b) if an index is used, sustainability impact of financial product compared with impact of index and of a broad market index; Taxonomy Regulation information (Article 5).

Source: Authors' own elaboration.

As a preliminary conclusion, the "product disclosures" are more concrete and usable than those on sustainability related risks, or the general provisions on PAIs. Some of the information on the PAIs to be included in the entity's website in accordance with CDR 2022/1288 is very detailed, sometimes extremely so (see, e.g., Table 1 Annex I of the CDR). In contrast, the product-related information is more client-oriented, and the legislator is more prescriptive about the contents, and the visual layout of the information, to make it more usable (Annexes II-V).

2.3. The SFDR in the information infrastructure: information supply rules (Taxonomy Regulation, Benchmarks Regulation and Corporate Sustainability Disclosures)

FMPs and FAs are expected to report information on sustainability risks, impacts and products. However, since they manage portfolios of financial instruments, and/or provide advice on such instruments, both types of entities **need to rely on other information pertaining to the issuers of such instruments**. This is what we identify as "information supply" rules. The main normative frameworks that shape that information are the Taxonomy Regulation, the Corporate Sustainability Reporting Directive (CSRD), and the Benchmarks Regulation.

The Taxonomy Regulation defines what is an environmentally "sustainable investment",[19] and it also requires FMPs and entities subject to sustainability reporting to report the ratio of their activities aligned with the TR, as defined by turnover, Capital Expenditures (CapEx) and Operating Expenditures (OpEx);[20] financial institutions, for their part, would have their own measures, including, Green Asset Ratio (GAR[21]). Thus, the TR operates as a point of reference for the SFDR obligations of precontractual disclosure. Furthermore, the Taxonomy Regulation also expands some of the information to be disclosed by FMPs and FAs, under the SFDR. For "dark green" products, Article 5 TR emphasises that the information on "how the objective is to be attained" should *"specify the proportion of investments in environmentally sustainable economic activities selected for the financial product, including details on the proportions of enabling and transitional activities"*.[22] For "light green" products Article 6 TR states that Article 5's "proportion of investments" shall apply *mutatis mutandis*, and be accompanied by a statement that the "do no significant harm" principle applies only to the investments in products that take into account the Taxonomy criteria, while the remaining investments do not.[23] Both the SFDR and the TR require figures on asset allocation, including for purposes of PAIs reporting (SFDR) and for purposes of Taxonomy-aligned activities.

The **CSRD**,[24] for its part, reformed the Accounting Directive, and replaced the Directive on Non-Financial Information (NFI), replacing also the non-committal term "non-financial" information with the more eloquent "sustainability reporting". The CSRD also expanded the subjective scope of application

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[19] Article 3 TR.

[20] Article 8 TR.

[21] See, e.g., EBA advises the Commission on KPIs for transparency on institutions' environmentally sustainable activities, including a green asset ratio. Available at: https://www.eba.europa.eu/publications-and-media/press-releases/eba-advises-commission-kpis-transparency-institutions.

[22] Article 5 3rd para. TR.

[23] According to Article 6 the statement shall read: "'The "do no significant harm" principle applies only to those investments underlying the financial product that take into account the EU criteria for environmentally sustainable economic activities. The investments underlying the remaining portion of this financial product do not take into account the EU criteria for environmentally sustainable economic activities.'.

[24] Directive 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting (Directive 2022/2464 will hereafter be referred to as CSRD, and Directive 2013/34/EU as the Accounting Directive).

of sustainability reporting, encompassing large firms from 2024 onwards, and other firms after 2025 and 2026.[25] The CSRD tries to ensure that firms report the information needed by FMPs to comply with their disclosure obligations under SFDR.[26] Indeed, **lack of data about corporates**, largely due to the fact that the SFDR was enacted long before the CSRD, has been a persistent concern among FMPs and FAs, as evidenced by the questions filed with the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).[27]

FMPs and FAs often rely on **sustainability indexes** as a basis for an invested portfolio, or as reference benchmarks to measure the sustainability performance of a specific portfolio, and indexes are even more important in the absence of complete sustainability reporting by investee companies (depends on the CSRD). The **Benchmarks Regulation** was reformed in 2019, contemporaneously to the SFDR,[28] showing the close link between the two texts, to include the Paris-aligned Benchmarks (PAB) and the Climate Transition Benchmark (CTB).[29] Products tracking a Paris-aligned Benchmark (PAB) or a CTB, often based on portfolios of shares or bonds of companies, are deemed to make sustainable investments.

Going beyond benchmarks and indices, the SFDR problem is that it requires very complex and costly disclosures by FMPs and FAs. These, in turn, must rely either on corporate disclosures that are themselves very complex, e.g., under the CSRD, or on information that may not be easily accessible, e.g., for firms outside the EU. This process of matching and research is beyond the capabilities of many intermediaries, which strengthens the role of third-party services providers (e.g., Morningstar Sustainalytics, MSCI, Refinitiv ESG, etc.).

2.4. The SFDR and the information infrastructure (II): "demand" rules (UCITS, AIFMD, MiFID II)

The SFDR not only relies on the rules that organise the "upstream" supply of information, but also on the rules that help convey the disclosures to investors. These include the rules that regulate firms providing investment services, such as MiFID, insurance companies, such as Solvency II, or fund managers (UCITS and AIFMD, among others).

The SFDR provisions expressly refer to the specific documents under MiFID, Solvency II, UCITS, AIFMD, etc., which are supposed to include the specific information under the SFDR. Article 5 SFDR, cross-refers to these legal texts, for purposes of the remuneration policies kept in accordance with UCITS, MiFID II, Solvency II, AIFMD, or Capital Requirements Directive (CRD). Article 6 SFDR states that the information on integration of sustainability risks should be part of the disclosures made to investors (e.g., Article 23 AIFMD, Article 24 (4) MiFID II) policyholders (Article 185 (2) Solvency II), and/or in the prospectus for UCITS (Article 69 UCITS Directive) or long-term funds (Article 23 Regulation 2015/760). Article 11 SFDR, for purposes of product information (on both "light green" and "dark green" products) in periodic reports cross-refers to the annual reports under Articles 22 AIFMD, 69 UCITS

[25] Recital (17) and Article 5 CSRD.

[26] Article 29b (1) 2nd para. and (5) (b) of Accounting Directive, as amended by CSRD.

[27] See EBA, EIOPA, ESMA, Questions and answers (Q&A) on the SFDR Delegated Regulation (Commission Delegated Regulation (EU) 2022/1288) JC 2023 18, 12 January 2024 (hereafter ESAs SFDR Q&A) Section IV (PAI Disclosures) Q 7, 10.

[28] Regulation 2019/2089 of 27 November 2019 amending Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks (hereafter: Benchmarks Regulation).

[29] Articles 19a-19c Benchmarks Regulation.

Directive, or national laws on pension products, or the periodic reports under Article 185(6) Solvency II for insurers, or Article 25(6) MiFID II.

Apart from "pure reporting" obligations the SFDR has required changes in the rules applicable to fund managers (UCITS[30] or AIFMs[31]) investment services firms (MiFID II[32]) or insurers distributing investment-based insurance products (IDD[33]), to ensure that these adjust their organisational requirements and operating conditions to account for sustainability risks and factors, as well as PAIs (for those firms choosing to report them). **For fund managers, the rules provide for a general duty to integrate sustainability risks,[34] and to have adequate resources and expertise,[35] and the responsibility of senior management,[36] as well as adjustments in due diligence policies,[37] conflicts of interests,[38] or risk management policies**.[39]

The adaptations in "demand" rules are not exactly analogous for fund managers and investment firms, though. Rules applicable to fund managers focus primarily on organisation, risk management, or due diligence. Rules applicable to "distribution" by investment firms (MiFID) and insurers (IDD) for their part, emphasise sustainability factors (risks, PAIs, or goals) in product governance[40] and suitability assessments,[41] so that firms take those factors into account when ensuring the "fit" between product and clients' "**sustainability preferences**",[42] individually or in the aggregate (whether such "preferences" can be defined with precision, though, is another matter).

Finally, the AIFMD and UCITS were amended in March 2024, to require that **funds marketed to retail investors *"include in the key information document the name of the fund and to ensure that such information is accurate, fair and clear and does not convey a misleading or confusing message that***

[30] Commission Delegated Directive 2021/1270 of 21 April 2021 amending Directive 2010/43/EU as regards the sustainability risks and sustainability factors to be taken into account for Undertakings for Collective Investment in Transferable Securities (UCITS) (hereafter: CDD 2010/43/EU, as amended).

[31] Commission Delegated Regulation (EU) 2021/1255 of 21 April 2021 amending Delegated Regulation (EU) No 231/2013 as regards the sustainability risks and sustainability factors to be taken into account by Alternative Investment Fund Managers (hereafter: CDR 231/2013 as amended).

[32] Commission Delegated Regulation (EU) 2021/1253 of 21 April 2021 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms (CDR 2017/565 as amended).

[33] Commission Delegated Regulation (EU) 2021/1257 of 21 April 2021 amending Delegated Regulations (EU) 2017/2358 and (EU) 2017/2359 as regards the integration of sustainability factors, risks and preferences into the product oversight and governance requirements for insurance undertakings and insurance distributors and into the rules on conduct of business and investment advice for insurance-based investment products (hereater: CDR 2017/2359).

[34] Articles 5a CDD 2010/43/EU, and 57 (1) 3rd para. of CDR 231/2013, as amended.

[35] Article 5 CDD 2010/43/EU, and 22 (3) of CDR 231/2013, as amended.

[36] Article 9 CDD 2010/43/EU, and 60 (2) (i) of CDR 231/2013, as amended.

[37] Article 23 (5) and (6) CDD 2010/43/EU, and 18 CDR 231/2013, as amended.

[38] Articles 33 CDR 2017/565, 3 (1) CDR 2017/2359, 17 CDD 2010/43/EU, and 30 CDR 231/2013, as amended.

[39] Articles 23 (1) (a) CDR 2017/565, 38 CDD 2010/43/EU, and 40 CDR 231/2013.

[40] Article 21 (1) CDR 2017/565, with reference to Article 16 (3) MiFID II.

[41] Articles 52 (2) (c) and 54 (2) (a) and (5) (9) and (12) CDR 2017/565, and 9 (1) (a) (4) and (6), and 14 CDR 2017/2359.

[42] Article 2 (7) CDR 2017/565, as amended, defines "sustainability preferences" as "a client's or potential client's choice as to whether and, if so, to what extent, one or more of the following financial instruments shall be integrated into his or her investment: (a) a financial instrument for which the client or potential client determines that a minimum proportion shall be invested in environmentally sustainable investments as defined in Article 2, point (1), of Regulation (EU) 2020/852 of the European Parliament and of the Council; (b) a financial instrument for which the client or potential client determines that a minimum proportion shall be invested in sustainable investments as defined in Article 2, point (17), of Regulation (EU) 2019/2088 of the European Parliament and of the Council; (c) a financial instrument that considers principal adverse impacts on sustainability factors where qualitative or quantitative elements demonstrating that consideration are determined by the client or potential client".

would wrongly entice investors",[43] and require the ESMA to develop guidelines to ensure that the information is fair, clear and not misleading (or, more accurately, to specify the circumstances in which the name of a fund is "unfair, unclear or misleading"[44]). As part of this mandate, ESMA published the Guidelines on funds' names using ESG or sustainability-related terms,[45] which provide minimum requirements to ensure that a fund's name duly reflects its investment strategy. These Guidelines are also connected to the efforts of the three ESAs to address "greenwashing" risks (to be discussed below).

2.5. The SFDR and the "pivot" towards transition finance

The legal framework adopted during a first stage from 2018 (the year were the Sustainable Finance Action Plan was published) to 2023 (the year where the Commission published its Recommendation on Transition Finance[46]) has been marked by **the attempt to create a solid, regulatory-based information infrastructure, where sustainability reporting by corporates under CSRD is processed and aggregated thanks to indexes (under Benchmarks Regulation), FMPs and FAs (under SFDR), and channeled to investors (also via MiFID or IDD)**. The side effect, however, is that this framework has focused primarily on the subset of "sustainable investments", on one hand, and sustainability risks, on the other hand. However, most of the market is not "sustainable" in the sense of the SFDR, and even less so in the sense of the (green) Taxonomy. The side effect is that firms that are trying to improve their key performance indicators (KPIs), e.g., by adopting credible transition plans, may be placed at a disadvantage.

The Commission tried to prevent a crystallisation of this binary distinction by adopting its **Transition Finance Recommendation in 2023**. The Recommendation must also be read in conjunction with the efforts to adopt the CSRD, which contemplates the disclosure of transition plans, though it does not mandate such plans,[47] and the recent Corporate Sustainability Due Diligence Directive (CSDDD), which makes such plans mandatory.[48] The Communication emphasises the role that transition planning (and transition plans) should have in the next stages of evolution. The Communication also mentions that **financial institutions have a crucial role to play in facilitating access to transition finance**.[49]

However, when it comes to putting this vision in terms of policy the Communication is more timid. Its definition of "transition finance" encompasses the financing of investments in Taxonomy-aligned economic activities, investments in undertakings with credible transition plans, or credible science-based targets (where proportionate, and provided they are supported by information ensuring integrity, transparency and accountability); the Commission is aware of the importance of "labels" to mobilise funding, and it refers to EU climate transition benchmarks and EU Paris-aligned benchmarks, as "transition finance".[50] However, it **fails to clarify where all the money for the transition is going**

[43] Directive (EU) 2024/927 of the European Parliament and of the Council of 13 March 2024 amending Directives 2011/61/EU and 2009/65/EC as regards delegation arrangements, liquidity risk management, supervisory reporting, the provision of depositary and custody services and loan origination by alternative investment funds, recital (66).

[44] Article 23(7) of the AIFMD and Article 69(6) of the UCITS Directive, as amended by Directive 2024/927.

[45] ESMA Final Report. Guidelines on funds' names using ESG or sustainability-related terms. 14 May 2024 ESMA34-472-440 (hereafter: ESMA Guidelines on funds' names).

[46] Commission Recommendation 2023/1425 of 27 June 2023 on facilitating finance for the transition to a sustainable economy (Transition Finance Recommendation).

[47] Recital (30) and Article 19b (2) (a) (iii) of the Accounting Directive as amended by the CSRD.

[48] Article 22 CSDDD.

[49] Transition Finance Recommendation, Recital (30).

[50] Transition Finance Recommendation, no. 2.2.

to come from (a notable omission also in the disclosure requirements for transition plans[51]). On "Financing Instruments to raise Transition Finance" the Communication merely refers to green or other sustainability loans, green or other sustainability bonds, and it is extremely vague on "equity financing and specialised lending". Crucially, while the Communication refers to the regulations on Green Bonds, Taxonomy, or Benchmarks and the Corporate Sustainability Reporting Directive, **it does not once refer to the SFDR**.

Although a Recommendation is not the most suitable instrument for a binding shift in law and policy, it would help to indicate that legislative reform may be needed if the funding gap is to be plugged. The SFDR is a crucial instrument in channeling investments towards desirable ends, like accomplishing the transition.

[51] Commission Delegated Regulation 2023/2772 of 31 July 2023 supplementing Directive 2013/34/EU of the European Parliament and of the Council as regards sustainability reporting standards (hereafter: ESRS 1) Disclosure Requirement E1 – 1 Transition Plan for climate change mitigation. Despite its level of detail, para. 17 only indicates that the transition plan shall include "(h) an explanation of how the transition plan is embedded in and aligned with the undertaking's overall business strategy and financial planning;" but not any sources of funding.

3. THE SFDR IMPERATIVE AND CONCEPTS: SUSTAINABILITY RISKS AND ADVERSE IMPACTS ON SUSTAINABILITY FACTORS; THE INTERPLAY BETWEEN DISCLOSURE REQUIREMENTS AND (PROFESSIONAL INVESTORS') BEHAVIOR AND PORTFOLIO STRATEGIES

This Section analyses in more detail some of the key SFDR features and concepts, notably the disclosures of "sustainability risks" and principal adverse impacts (PAIs) (3.1.) the implications of entity and product-level disclosures (3.2.) the interplay between disclosures and standards of conduct (3.3.) and the implications for transition finance (3.4.).

3.1. SFDR features: sustainability risk and principal adverse impact (PAI)

The SFDR requires FMPs and FAs to report to investors on both the integration of sustainability risks that may affect the value of their investments and on the consideration of adverse sustainability impacts of such investments on the environment and society, with a view to supporting the EU's climate and sustainability neutrality objectives, believing that that disclosure to end-investors on the integration of sustainability risks and the consideration of negative impacts is "*insufficiently developed because such disclosures are not yet subject to harmonised requirements*".[52]

A 'sustainability risk' is defined as any "*environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment*" (Article 2(22) SFDR).[53] The provision clarifies the relevance of sustainability from a financial perspective; with this meaning, the consideration of all relevant sustainability risks becomes part of the general duty of FMPs and FAs to act in the best interests of end investors, in line with European and national requirements.[54]

Although the concept of **sustainability risk** according to Article 2 SFDR explicitly refers to all environmental, social and governance factors, a review of the studies and reports produced in this area shows that current knowledge is largely **focused on** the sustainability risk posed by **climate change**, in particular global warming.[55] Climate-related sustainability risk includes both physical risks – defined as "*the possibility that the economic costs of (1) climate-change related extreme weather events or/and (2) more gradual changes in climate, might erode the value of financial assets and/or increase liabilities*"[56] –

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[52] Recital n. 5 SFDR.

[53] According to recital 14 of the SFDR, the value of the investment should be considered to be the one specified in sectoral legislation, and "*in particular in Directives 2009/65/EC, 2009/138/EC, 2011/61/EU, 2013/36/EU, 2014/65/EU, (EU) 2016/97, (EU) 2016/2341, or delegated acts and regulatory technical standards adopted pursuant to them*".

[54] Such as the requirement of conducting adequate due diligence prior to making investments, provided for in Directives 2009/65/EC, 2009/138/EC, 2011/61/EU, 2013/36/EU, 2014/65/ EU, (EU) 2016/97, (EU) 2016/2341, and Regulations (EU) No 345/2013 and (EU) No 346/2013, as well as in national law governing personal and individual pension products (see recital 12 SFDR).

[55] FINANCIAL STABILITY BOARD (FSB), *The Implications of Climate Change for Financial Stability*, 23 November 2020. Available at: https://www.fsb.org/2020/11/the-implications-of-climate-change-for-financial-stability/, p. 4. But see also NETWORK FOR GREENING THE FINANCIAL SYSTEM (NGFS), *A Call for Action: Climate Change as a Source of Financial Risk*, April 2019. Available at: https://www.ngfs.net/sites/default/files/medias/documents/ngfs_first_comprehensive_report_-_17042019_0.pdf; and TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES (TCFD), *Recommendations of the Task Force on Climate-Related Financial Disclosures*, June 2017. Available at: https://assets.bbhub.io/company/sites/60/2020/10/FINAL-2017-TCFD-Report-11052018.pdf.

[56] FSB, The Implications of Climate Change for Financial Stability, at p. 4. See also IPCC, Climate Change 2021: The Physical Science Basis. Contribution of Working Group I to the Sixth Assessment Report of the Intergovernmental Panel on Climate Change (Valerie Masson-Delmotte et al. eds.), Cambridge University Press, 2021.

and transition risks, which refer to the risks arising from changes in government policy towards low-carbon practices, the development of new technologies and shifts in market references.[57]

The same definition of sustainability risk as in Article 2 SFDR is recalled by Commission Delegated Directive (EU) 2021/1270 of 21 April 2021, which amends Directive 2010/43/EU to require undertakings for collective investment in transferable securities (UCITS) to also take into account sustainability risks and sustainability factors, and by Commission Delegated Regulation (EU) 2021/1255 of 21 April 2021 amending Delegated Regulation (EU) 231/2013 as regards the sustainability risks and sustainability factors to be taken into account by alternative investment fund managers.

More generally, **growing investor awareness** of the financial implications of sustainability risks, and in particular climate-related financial risks,[58] has been a driving force behind the increased demand for corporate sustainability information in recent years, which ultimately led to the adoption of the **CSRD**,[59] and other information supply rules.

Principal adverse impacts are understood "*as those impacts of investment decisions and advice that result in negative effects on sustainability factors*"[60], where sustainability factors are intended as "*any environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters*" (Article 2(24) SFDR).

While disclosure obligations on the integration of sustainability risks in investment decision making provide transparency on how FMPs consider the impact of ESG factors on the value of the financial asset, disclosure obligations on **PAIs** provide transparency on the **negative ESG impacts** associated with an FMP's investment decisions, regardless of whether these negatively affect the value of the investment or the financial product.[61]

The disclosure of PAIs is linked to the principle '**do not significant harm**' principle, which is a core component of the concept of sustainable investment.[62] For this reason, "*financial product disclosures about the 'do not significant harm' principle should explain how the indicators for adverse impacts have been taken into account*".[63]

In fact, **adverse impacts on ESG factors** are regulated through transparency rules, but are **not prohibited**, in line with the approach adopted by the European Union Sustainable Finance Action Plan[64]. There is **no 'level' of PAI that is unacceptable** under the SFDR regime, nor is there a formal obligation for FMPs to take specific measures to prevent and eliminate adverse impacts (but see *infra* paragraph 3.3). This is the case both at the entity level and when it is disclosed that a financial product takes PAI into account (*infra* paragraph 3.2).

[57] FSB, The Implications of Climate Change for Financial Stability, at p. 4. See also, F. E. Mezzanotte Recent Law Reforms in EU Sustainable Finance: Regulating Sustainability Risk and Sustainable Investments, American University Business Law Review 11, no. 2, 2023, 215-276, at 224 ff.

[58] Recital 11 CSRD.

[59] The importance of reliable, comparable and relevant information on sustainability risks for market participants and advisers have been recognized by the European Council in its conclusions of 5 December 2019 on the deepening of the Capital Markets Union, which was a driver to the European Commission development of the CSRD. See CSRD recitals (4), (19) and (21).

[60] Recital 20 SFDR.

[61] E. Partiti , From disclosures to classification regime and sustainability due diligence. Tackling the flaws of the Sustainable Finance Disclosure Regulation, TILEC Discussion Paper No. 2023-05. Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4387626, at p. 9.

[62] Article 2 (17) SFDR. See supra 2.1.

[63] Recital 22 CDR 2022/1288.

[64] High-Level Expert Group on Sustainable Finance (2018) Financing a Sustainable European Economy – Final Report. See E. Partiti, *From disclosures to classification regime and sustainability due diligence. Tackling the flaws of the Sustainable Finance Disclosure Regulation*, at p. 7.

The consideration of principal adverse impacts, whether material or likely to be material, of investment decisions on sustainability factors, should include the integration of the procedures for considering such PAIs alongside the relevant financial risks and relevant sustainability risks;[65] "*the information on such procedures might describe how financial market participants discharge their sustainability-related stewardship responsibilities or other shareholder engagements.*"[66]

On order to disclose on PAIs, financial advisers (**FAs**) **use information** on principal adverse impacts on sustainability factors that is provided **by FMPs**; "*information provided by financial advisers on whether and how they take into account principal adverse impacts on sustainability factors within their investment or insurance advice should therefore clearly describe how the information from financial market participants is processed and integrated in their investment or insurance advice. In particular, financial advisers that rely on criteria or thresholds concerning principal adverse impacts on sustainability factors that are used to select, or advise on, financial products, should publish those criteria or thresholds.*"[67]

Although the concept of adverse impact is not unique to the SFDR,[68] it takes on a whole new meaning with this disclosure infrastructure, particularly because of the CDR 2022/1288, which describes the content of the required information, sets out the Regulatory Technical Standards (RTS), and provides for templates for the presentation of the information, in order to ensure clarity and comparability of such information for the benefit of investors.[69] However, being SFDR a disclosure regime, it is not unexpected that it lacks a definition of harmful activities or clear thresholds for positive and adverse impacts.[70]

Annex 1 of CDR 2022/1288 identifies **indicators that always lead to principal adverse impact**, but **FMPs must further choose additional indicators** of adverse impacts on sustainability factors among the ones listed in **Annex II and III**. According to Article 6 CDR 2022/1288, the description (and prioritisation)[71] of the principal adverse impacts of investment decisions on sustainability factors should include information on:

- one or more additional climate and other environment-related indicators, such as greenhouse gases (GHG) emission, carbon footprint, emission of water, or activity negatively affecting biodiversity;
- information on one or more additional indicators for social and employee matters, respect for human rights, anti-corruption and anti-bribery matters, such as lack of human rights policy, incidents of discrimination, or lack of anticorruption and antibribery policies;
- information "*on any other indicators used to identify and assess additional principal adverse impacts on a sustainability factor*".

Despite the efforts of CDR 2022/1288, however, **it remains unclear how the concept of PAIs is coordinated with other concepts in the SFDR**. In particular, it was found that 80% of FMPs face

65 Recital 18 SFDR.

66 Ibid.

67 Recital 8 CDR 2022/1288.

68 For example, the Taxonomy Regulation defines an economic activity as contributing substantially to climate change adaptation also when that activity "*includes adaptation solutions that either substantially reduce the risk of the adverse impact of the current climate and the expected future climate on that economic activity or substantially reduce that adverse impact, without increasing the risk of an adverse impact on people, nature or assets;*" (article 11 (1) (a) TR). Also, adverse impacts should be covered by the sustainability reporting under the CSDR.

69 Recital 29 CDR 2022/1288.

70 E. Partiti, *From disclosures to classification regime and sustainability due diligence*, p. 7.

71 While Article 7 CDR 2022/1288 regulates the descriptive criteria for policies to identify and prioritise the principal adverse impacts of investment decisions on sustainability factors, it implies the possibility for market participants to prioritise some sustainability factors over others.

methodological challenges with the requirement to take into account the PAI indicators set out in the Regulatory Technical Standards (RTS) at entity level for the 'do no significant harm' test at product level,[72] and concerns were raised about the different methodologies used by product manufacturers to apply the same concept of taking into account PAI indicators in compliance with MiFID II and IDD rules.[73]

Following two occasions when the ESAs provided guidance on the interpretation and implementation of the PAI indicators,[74] in April 2022 **the European Commission mandated the** Joint Committee of the **ESAs to review** several aspects of CDR 2022/1288. The ESAs published their consultation paper in April 2023[75], the results of which were considered in the **final report** published in December 2023.[76] The proposed changes to the SFDR mainly relate to the **design options** for the '**do not significant harm**' **disclosure**, the **simplification of the templates** and other technical adjustments.[77]

3.2. SFDR features (II): entity and product-level disclosure requirements

FMPs and FAs shall consider ***sustainability risks*** at both the entity and the product level of disclosure (respectively, Article 3 and Article 6 SFDR). Also, financial advisers who employ fewer than three persons – and which are normally exempted by the SFDR's provisions – are required to factor in sustainability risks in their advisory processes.[78] FMPs and FAs shall also consider the ***adverse sustainability impacts*** of investment decisions and advice (Article 4 SFDR), as well as at the financial product level (Article 7 SFDR).

More specifically, every FMPs and FAs under SFDR should disclose their policies on the integration of sustainability risks into investment decision making or advice by publishing them on their website (Article 3 SFDR).

They are also required to explain in pre-contractual disclosures how they integrate sustainability risks into their investment decisions or investment advice, as well as the results of their assessment of the likely impact of sustainability risks on the returns of the financial products they offer or advise on (Article 6 SFDR). Since all financial products must consider the impact of sustainability risks and their effect on the value of the financial product, in the terms described above, Article 6 becomes the 'default' product category.

Transparency on the integration of sustainability risks can be avoided when the ESAs consider an unlikely scenario[79] – that FMPs or FAs do not consider these risks to be relevant. In this case, they must publish an explanatory statement describing the reasons for noncompliance.[80] In both cases, however, the way in which information is disclosed should be consistent with the relevant EU sectoral discipline.[81]

[72] See Commission Summary of responses to Public Consultation and Targeted Consultation, p. 5.

[73] Ibid. at p. 7.

[74] EBA, EIOPA, ESMA, Clarifications on the ESAs' draft RTS under SFDR JC 2022 23, 2 June 2022; ESAs SFDR Q&A.

[75] EBA, EIOPA, ESMA, Joint Consultation Paper 'Review of SFDR Delegated Regulation regarding PAI and financial product disclosures', 12 April 2023 (JC 2023 09).

[76] EBA, EIOPA, ESMA (ESAs) Final Report on draft Regulatory Technical Standards on the review of PAI and financial product disclosures in the SFDR Delegated Regulation, 4 December 2023 (JC 2023 55).

[77] *Supra* p. 5.

[78] Recital 6 SFDR.

[79] ESAs SFDR Q&A Section V, Q17.

[80] Article 6 SFDR.

[81] Article 6, para. 3, SFDR states that the information should be disclosed, e.g., for AIFMs, in the disclosures to investors referred to in Article 23(1) of Directive 2011/61/EU, for insurance undertakings, in the provision of information referred to in Article 185(2) of Directive 2009/138/EC or, where relevant, in accordance with Article 29(1) of Directive (EU) 2016/97, etc.

If the sustainability risk assessment concludes that sustainability risks are relevant to the financial product, the extent to which these sustainability risks could affect the performance of the financial product should be disclosed either qualitatively or quantitatively.[82]

Finally, in order to align the incentives of financial market participants, Article 5 SFDR requires FMPs and FAs to include in their **remuneration policies** information on how those policies are consistent with the integration of sustainability risks and to publish this information on their websites.

With regard to transparency of adverse sustainability impacts, instead, Article 4 SFDR regulates disclosure at the entity level, requiring financial market participants to publish a yearly statement on how they consider PAIs.[83] Disclosure consists in a "*statement on due diligence policies with respect to those impacts, taking due account of their size, the nature and scale of their activities and the types of financial products they make available*". The statement should at least include:

- information about the policies on the identification and prioritisation of PAIs and the relative indicators;
- a description of the PAIs and of any actions in relation thereto taken or, where relevant, planned;
- brief summaries of engagement policies in accordance with Article 3g of the Shareholders Directive (SHRD), where applicable;
- reference to the adherence to responsible business conduct codes and internationally recognised standards for due diligence and reporting and, where relevant, the degree of their alignment with the objectives of the Paris Agreement.[84]

Unlike the obligation to consider sustainability risks, which applies to all financial market participants and their products in scope, the disclosure of PAIs is only mandatory for large FMPs exceeding the criterion of an average number of 500 employees during the financial year[85], on the one hand, and for FMPs that are parent companies of a large group as defined in Article 3(7) of Directive 2013/34/EU and exceeding the criterion of an average number of 500 employees on a consolidated basis, on the other hand.[86]

Other FMPs are left with the option not to comply with the transparency rules, but must then explain the reasons why they do not take into account the negative impacts of investment decisions on sustainability factors, including, when relevant, information on whether and when they intend to take such negative impacts into account.[87]

Conversely, FAs are always free to choose whether to consider in their investment or insurance advice the principal adverse impacts on sustainability factors, or whether, taking due account of their size, the nature and scale of their activities and the types of financial products they advise on, they consider PAIs of their investments not to be relevant. In the latter case their noncompliance must be explained in their websites.[88]

[82] Recital 15 SFDR.

[83] Article 4 CDR 2022/1288 requires FMPs referred to in Article 4 SFDR to publish the information on their website, in a separate section titled 'Statement on principal adverse impacts of investment decisions on sustainability factors'.

[84] Article 4, par. 2, SFDR.

[85] Article 4, par. 3, SFDR.

[86] Article 4, par. 4, SFDR.

[87] Article 4, par. 1(b), SFDR.

[88] Article 4, par. 5, SFDR, but see also Article 12 and Article 13 CDR 2022/1288 with regards to the content of the statement by, respectively, FMPs or FAs that do not consider adverse impacts of their investments decisions on sustainability factors.

As mentioned, the contents and methodology of the disclosure are described in detail in CDR 2022/1288.

At the product level, disclosure of whether and how PAIs are taken into account is not always mandatory. According to Article 7 of the SFDR, only FMPs that disclose the PAIs of their investments at the entity level – or because they are required to do so under Article 4 SFDR, or because they choose to do so – should include in the pre-contractual disclosure "*a clear and reasoned explanation of whether, and, if so, how a financial product considers principal adverse impacts on sustainability factors*". This obligation applies to all SFDR investment products, but there is no further guidance in the SFDR other than the templates to provide the information required by Article 4.

Smaller FMPs, which have the option not to consider PAIs at the entity level, may still produce or manage a financial product that considers PAIs as defined in Article 7.[89] However, the use of PAI indicators becomes mandatory at product level for purposes of demonstrating that an investment qualifies as a 'sustainable investment' under Article 9 SFDR. According to the ESAs, indeed, disclosure of 'do not significantly harm" for sustainable investments under Article 2(17) SFDR requires the use of PAIs.[90]

On the contrary, sustainability indicators used to measure the achievement of environmental or social characteristics for financial products under Article 8 SFDR or the sustainable investment objective (e.g. the impact of the financial product for products under Article 9 SFDR) may include, but are not required to include, PAI indicators. According to the ESAs, "*there is no direct link between sustainability indicators and PAI indicators*".[91]

Overall, the entity-level disclosure requirements have not been received with great enthusiasm by market participants, most of whom have called for greater simplification and streamlining of the entire sustainable finance framework, highlighting the risk of overlap between the different European instruments, and, especially, between the transparency requirements for PAIs under SFDR and the reporting requirements for entities subject to CSDR.[92] In particular, the consultation phase showed that there is no clear consensus on the usefulness of entity-level disclosure of remuneration policies (39% in support, 26% against) and adverse sustainability impacts (31% in support, 31% against). This is particularly understandable when considering that PAI disclosure is required regardless of the fact that the financial market participant's investment decisions are made through financial products covered by the SFDR or in other way.[93]

Further, a great majority of FMPs (over 66% of the respondents) stressed the difficulty of coordination between PAIs product and entity level disclosure, especially with regards to the consideration of PAIs transparency at entity level and "do no significant harm" (DNSH) disclosure requirement at product level.[94]

Conversely, the responses showed a degree of support for the current transparency requirements for sustainability risk policies (49% agree, 15% disagree).[95]

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[89] ESAs SFDR Q&A Section IV (PAI disclosures) Q2.

[90] EBA, EIOPA, ESMA, Clarifications on the ESAs' draft RTS under SFDR JC 2022 23, 2 June 2022, at p. 2.

[91] Ibidem.

[92] Opinion is divided as to whether the SFDR is the right place to establish entity-level disclosure requirements for FMPs and financial advisers, particularly between the different 'stakeholder' groups. The majority of FMPs and financial advisors responded that they do not believe the SFDR is the right place to include entity-level disclosures, while the majority of NGOs are in favour of including such disclosures in the SFDR. See Commission Summary of responses to Public Consultation and Targeted Consultation, at p. 7.

[93] ESAs SFDR Q&A, Section IV (PAI disclosures) Q23.

[94] Commission Summary of responses to Public Consultation and Targeted Consultation, at p. 5.

[95] Ibid. at p. 8.

3.3. Interplay between disclosure duties and standard of conduct

The SFDR establishes a complementary disclosure regime that adds to other sectoral disciplines (like MiFID, UCITS, AIF, etc.) and does not formally introduce conduct obligations in relation to the consideration of sustainability risks or material adverse impacts on sustainability factors.

In substance, however, FMPs and FAs do not seem to be able to ignore sustainability risks or PAIs in the conduct of their activities.

First, when Article 3 SFDR requires FMPs and FAs to state *how* they integrate sustainability risks, it actually assumes that these risks *are* integrated into their investment decision-making process or investment and insurance advice, respectively. This is consistent with the relevance of the concept of 'sustainability risk' from a financial perspective that derives from the definition of sustainability risk as a sustainability condition that can cause an actual or potential negative impact on *the value of the investment*.[96] It follows that the consideration of sustainability risk by FMPs and FAs becomes part of the general duties of due diligence and acting in the best interests of the client, as mentioned above.[97]

It is, however, evident that the consideration of sustainability risks, both in the context of entity-level policies and product-specific approaches, can be done through different means and strategies (portfolio alignment, risk profile management, etc.), and the SFDR does not take a position on these points.

Second, the use of the term 'consideration' instead of 'information' in Article 4, paras. 1 to 4, SFDR, with regards to transparency of adverse sustainability impact at entity level, may imply a certain duty of conduct. According to the ESA's, where FMPs are required to *"consider principal adverse impacts of investment decisions on sustainability factors"* (emphasis added), it implies that FMPs must not only *disclose* the information, but also *mitigate* the principal adverse impacts on sustainability factors. In their recent opinion on the assessment of the SFDR, the ESAs also advise the Commission to consider "*making 'consideration' of PAIs of investment decisions on sustainability factors (…) mandatory for products qualifying for the new sustainability product category*". [98]

Finally, it can be seen as a statement of due diligence that large FMPs are required to seek information and provide disclosure on the negative impacts associated with their investment decisions, and consequently decide to commit to taking action to reduce their impact.[99]

3.4. Implications for transition finance

To ensure a timely and orderly transition while safeguarding the competitiveness of the EU economy, transition finance will be needed.[100] The Commission Transition Finance Recommendation[101] "aims to support market participants that wish to obtain or provide transition finance by offering practical suggestions on how to approach transition finance"[102], in line with the EU Commission's 'Strategy for Financing the Transition to a Sustainable Economy'.[103]

[96] Article 2 (22) SFDR.

[97] At paragraph 3.1.

[98] Joint ESAs Opinion on the SFDR, at p. 19-20.

[99] E. Partiti, From disclosures to classification regime and sustainability due diligence, p. 11.

[100] Recital (3) Commission's Recommendation (EU) 2023/1425. See supra 2.5.

[101] Commission Recommendation (EU) 2023/1425 of 27 June 2023 on facilitating finance for the transition to a sustainable economy.

[102] Par. 1.2 Commission's Recommendation (EU) 2023/1425.

[103] Communication from the Commission on a 'Strategy for Financing the Transition to a Sustainable Economy', COM/2021/390 final.

According to the Commission's Recommendation (EU) 2023/1425 'transition finance' means "financing of investments compatible with and contributing to the transition, that avoids lock-ins, including:

- investments in portfolios tracking EU climate transition benchmarks and EU Paris-aligned benchmarks ('EU climate benchmarks');
- investments in Taxonomy-aligned economic activities, including: transitional economic activities as defined by Article 10(2) of Regulation (EU) 2020/852 for the climate mitigation objective; Taxonomy-eligible economic activities becoming Taxonomy-aligned in accordance with Article 1(2) of Commission Delegated Regulation (EU) 2021/2178 over a period of maximum 5 (exceptionally 10) years;
- investments in undertakings or economic activities with a credible transition plan at the level of the undertaking or at activity level;
- investments in undertakings or economic activities with credible science-based targets, where proportionate, that are supported by information ensuring integrity, transparency and accountability".[104]

This is not very specific about where the sources of funding may come from, and what incentives there may be to provide them,[105] a paucity of details compounded by an almost absence of references to the SFDR, which is mentioned only obliquely, in recital no. 6, as part of a reference to the TR (which amends the SFDR).[106] However, the SFDR disclosure regime appears to be aimed at mobilising capital for transition finance. Recital 8 of the SFDR states: "*as the Union is increasingly faced with the catastrophic and unpredictable consequences of climate change, resource depletion and other sustainability-related issues, urgent action is needed to mobilise capital not only through public policies but also by the financial services sector*". Sadly, the SFDR text is not more explicit about *how* the transparency regime can concretely facilitate the development of transition finance.

The relevance of the SFDR for transition finance would seem to be at least threefold.

First, from a general perspective, transition finance requires that clear signals are given to investors with regard to their investments to avoid stranded assets and to raise sustainable finance. If a disclosure regime functions correctly and is properly understood by end-investors, it may well be able to help steer investors towards transition finance. In theory, sustainability disclosures under SDFR may then help streamline the exchange of information between financial intermediaries and undertakings in transition, providing useful information for investors and financial intermediaries that are themselves committed to transitioning. The information will help financial intermediaries and investors decide on what to include or not include in investment products as well as assess the implications of different investment time-horizons and the risks of stranded assets.[107]

However – and despite the acknowledged usefulness of action at the European level to enhance transparency through sustainability reporting in financial services – it is widely recognised that the existing SFDR framework still suffers from a number of significant limitations, including a lack of legal clarity on key concepts, the complexity of certain disclosures, in particular for retail investors, the

[104] Par. 2.2 Commission's Recommendation (EU) 2023/1425.

[105] Supra 2.5.

[106] Recital 6 Commission's Recommendation (EU) 2023/1425, and unlike other regulatory acts such as the Benchmarks regulation or TR (see paras. 5 and 6).

[107] Recital 33 Commission's Recommendation (EU) 2023/1425.

limited relevance of certain disclosure requirements, and data availability problems. These limitations have reduced the effectiveness and usability of the framework[108], which could be improved.[109]

Second, given that companies are invited to use one or a combination of transition-related financial instruments to access transition finance, such as specific types of loans or capital market issues with specific characteristics[110], making 'sustainable' financial products easily recognisable could help investors decide where to allocate their capital. All the more so if, as many have suggested, Sections 8 and 9 of the SFDR will further characterise financial products with a view to labelling them.[111]

Third, the information that FMPs and FAs are required to disclose under the SFDR may also be useful to public authorities, which can use this information to better understand how to incentivise the transition to a sustainable growth of the real economy.

Finally, it can be seen as a statement of due diligence that large FMPs are required to seek information and provide disclosure on the negative impacts associated with their investment decisions, and consequently decide to commit to taking action to reduce their impacts.

All this considered, however, it does not seem that SFDR as it is now would be able to make a strong contribution to the development of transitioning finance, while much work would be needed to make disclosed information better understandable and comparable as well as to make sustainable financial products well recognisable by market participants.[112]

[108] See the Commission Summary of responses to Public Consultation and Targeted Consultation, at p. 2.

[109] EBA, EIOPA, ESMA, Joint Consultation Paper 'Review of SFDR Delegated Regulation regarding PAI and financial product disclosures'.

[110] Par. 8.1 Commission's Recommendation (EU) 2023/1425.

[111] EBA, EIOPA, ESMA, Joint Consultation Paper 'Review of SFDR Delegated Regulation regarding PAI and financial product disclosures', no. 80.

[112] A slight majority of the total respondents to the EU Commission consultation (153 out of 294) did not agree that SFDR has successfully directed capital towards investments deemed sustainable, including transitional investments; see Commission Summary of responses to Public Consultation and Targeted Consultation, at p. 5.

4. THE SFDR EMPOWERMENT, ITS SHORTCOMINGS, AND POSITIVE EFFECTS

This section analyses how the SFDR, despite its declared "neutrality", has come to be used as a *de facto* labeling system (4.1.), and the risks this presents for greenwashing (and green bleaching) (4.2.) the SFDR sustainability criteria, both the "negative" ones, like "adverse impacts" and "do no significant harm") (4.3.) and the "positive" ones (including impact investment) (4.4.) It also discusses briefly the uses of entity-level information (4.5.) and provides a summary of the challenges for final (especially retail) investors (4.6.)

4.1. The SFDR: from its objectives and alleged "neutrality" to its use as a de facto labelling system?

The SFDR tries to further three main objectives: (1) integration of sustainability risks (including on remuneration), (2) consideration of adverse sustainability impacts, and (3) product transparency, and channeling capital towards sustainable investments. The Commission, however, has clarified that Article 8, and even Article 9, the more demanding "dark green", are "neutral" in terms of product design,[113]i.e., they do not impose specific design features, but merely require financial intermediaries to report how the sustainable investment objective is realised (or how sustainability characteristics promoted).

The above objectives remain relevant today. However, it is equally admitted that the SFDR has become a ***de facto* labelling scheme**, i.e., despite its many implications, the SFDR is the text that helps market "**Article 8 products**" and "**Article 9 products**".[114] And even from this reductionist perspective (or because of it) the disclosures are insufficient to protect investors, ensure comparability, or channel capital towards sustainable investments.[115]

The **Commission** accepts this, and in its Consultation regarding the SFDR it considers the establishment of a **categorisation system for financial products based on precise criteria**. The options considered are (1) to split the categories in a different way, for example focusing on the type of investment strategy, or the contribution to sustainability objectives (distinguishing between transition, impact, sustainable or negatively-screened products), and (2) to roughly transform Article 8 and 9 into separate product categories (i.e., use existing concepts).[116]

4.2. The SFDR "labelling" (II). Self-assessment and "greenwashing"

4.2.1. The SFDR elements prone to greenwashing

The SFDR relies on a **system of self-assessment** by FMPs and FAs, which must process complex information, and then provide investment products or advice, subject to transparency requirements. This is problematic, because what the SFDR tries to do (require different levels of disclosure depending

[113] SFDR Q&A Section V (Financial product disclosures) Q 1 (Article 9 remains neutral in terms of product design) and Q2 (for Article 8). The answer was provided by the European Commission on the interpretation of the SFDR, published on 14 July 2021. (Q1, on Article 9, amended on 6 April 2023 and the question was amended on 12 December 2023).

[114] See Commission Summary of responses to Public Consultation and Targeted Consultation, p. 5. An 89% of respondents agree that the broad goal (enhancing transparency) remains relevant. An 83% point out that the SFDR is mostly used as a labelling scheme for marketring purposes.

[115] Most respondents consider that SFDR has not strengthened protection for investors or ensured comparability (62%) whereas a slight majority considers that it has not channelled capital towards sustainable investments (52%). Commission Summary of responses to Public Consultation and Targeted Consultation, p. 5.

[116] See Commission Targeted Consultation Document, section 4.

on the type of product to a supposedly discerning investor) is very different from what it actually does (create labels of distinctions used for marketing purposes). Thus, **investors may be confused**, as they may not understand the difference between legal concepts as ambiguous and slippery such as "sustainable characteristics" and "sustainable investment as an objective". **From an investor perspective, other concepts, such as "ethical/value" investment or "impact" investment may be easier to understand, and /or aligned with their preferences.**

Furthermore, entities are required to disclose how the characteristics (Article 8) or objectives (Article 9) are met, while investors are expected to discriminate, but **without** clear criteria, or **meaningful thresholds** (especially under Article 8 products) to conclude when a product can be considered to promote sustainability characteristics.

In third place, by **failing to include** the possibility of **"transition" investments**, the SFDR fails to duly accommodate a large swathe of the market. This has two problems. First, it fails to provide firms seeking to undertake a transition with what would be a much welcome source of funding. Second, it increases the incentives for FMPs and FAs to lump together into Article 8 or 9 (especially the former) funds that may be very different.

A fourth problem involves the SFDR's **lack of** clear **enforcement mechanisms**. Its self-assessment system means that there is relatively light external verification, which may result in non-compliance with its provisions by FMPs and FAs.

These elements make the sector of investment products prone to "**greenwashing**". As the next point illustrates, this has prompted efforts by the European Supervisory Authorities (ESAs) to address the problem.

4.2.2. The ESAs efforts to tackle greenwashing in context

The ESAs efforts on green washing comprise (1) a high-level common understanding, (2) ESA-specific actions, and (3) advice to the Commission in the form of reports.

1. The high-level common understanding is a welcome first step to provide a single conceptual basis for "greenwashing", which is understood as:

   > "a practice whereby sustainability-related statements, declarations, actions, or communications do not clearly and fairly reflect the underlying sustainability profile of an entity, a financial product, or financial services. This practice may be misleading to consumers, investors, or other market participants".[117]

2. In addition to the high-level common understanding, some of the ESAs have developed their own specific initiatives. The **ESMA** has its **guidelines on funds' names** using ESG or sustainability-related terms.[118] These guidelines follow **a prescriptive, quasi-regulatory approach**, requiring an 80% investment in accordance with the binding elements of the investment strategy, as well as pre-specified exclusions. This will be complemented by the ongoing Common Supervisory Action (CSA) between the ESMA and the National Competent Authorities (NCAs), which is expected to be completed by the end of 2024.[119]

[117] ESAs put forward common understanding of greenwashing and warn on risks. 1 June 2023. ESMA71-545613100-2323. Available at: https://www.esma.europa.eu/document/esas-put-forward-common-understanding-greenwashing-and-warn-risks-press-release.

[118] ESMA Guidelines on funds' names.

[119] ESMA and NCAs to assess disclosures and sustainability risks in the investment fund sector. 6 July 2023. Available at: https://www.esma.europa.eu/press-news/esma-news/esma-and-ncas-assess-disclosures-and-sustainability-risks-investment-fund.

The **EIOPA**, for its part, issued in 2023 for public consultation,[120] an **Opinion** on sustainability claims and greenwashing in the insurance and pensions sector,[121] with **four principles about sustainability claims**, to ensure that they are: (1) accurate, precise and consistent, (2) updated, (3) substantiated with clear reasoning, and (4) accessible,[122] and examples of bad and good practices. After receiving the responses, the EIOPA released a Feedback statement with stakeholders' feedback, and its response,[123] where it allayed the (primarily industry) concerns about the presence of new (potentially inconsistent) standards and insisted that it would keep its four principles.

3. Furthermore, in response to a **Commission's request** to deliver advice on greenwashing risks and sustainability-related supervision,[124] **the three ESAs published** their progress reports, and then final **reports on greenwashing** practices in the respective domains, i.e., banking for the EBA,[125] securities (including funds and investment services for ESMA[126]) and insurance and pension funds for EIOPA.[127] These guidelines provide a comprehensive assessment of greenwashing risks, and pathways to solutions.

The **ESAs Reports vary in their sources and their assessment**: the ESMA and EIOPA rely on reporting by NCAs, concluding that there are few reported occurrences; the ESMA attributes that to limitations in the reporting to NCAs,[128] while the EIOPA considers that most companies are compliant.[129] The EBA, for its part, relies on external information supplied by an ESG data provider and reports a growing number of alleged cases of greenwashing in almost all geographical areas, including the EU, and including the financial sector,[130] even though, when it requested NCAs to report greenwashing complaints, only one competent authority (CA) out of 29 responded having received a complaint.[131]

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[120] EIOPA. Consultation on the Opinion on sustainability claims and greenwashing in the insurance and pensions sectors. Available at: https://www.eiopa.europa.eu/consultations/consultation-opinion-sustainability-claims-and-greenwashing-insurance-and-pensions-sectors_en.

[121] EIOPA on the Opinion on sustainability claims and greenwashing in the insurance and pensions sectors. EIOPA-BoS-23/450. 17 November 2023.

[122] Principle 1: Sustainability claims made by a provider should be accurate, precise, and consistent with the provider's overall profile and business model, or the profile of its product(s); Principle 2: Sustainability claims should be kept up to date, and any changes should be disclosed in a timely manner and with a clear rationale; Principle 3: Sustainability claims should be substantiated with clear reasoning and facts; Principle 4: Sustainability claims and their substantiation should be accessible by the targeted stakeholders.

[123] EIOPAFeedback statement Consultation on the Opinion on sustainability claims and greenwashing in the insurance and pensions sectors EIOPA(2024)0020933. EIOPA-BoS-24/161. 30 April 2024.

[124] Commission Request for input to the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) related to greenwashing risks and supervision of sustainable finance policies. May 2022. Available at: https://www.esma.europa.eu/sites/default/files/library/request_to_esas_on_greenwashing_monitoring_and_supervision.pdf.

[125] EBA Progress report on Greenwashing and Supervision. 31 May 2023 EBA/REP/2023/16; EBA Greenwashing Monitoring and Supervision. Final Report. 4 June 2024. EBA/REP/2024/09 (hereafter: EBA Greenwashing Report).

[126] ESMA Progress Report on Greenwashing Response to the European Commission's request for input on "greenwashing risks and the supervision of sustainable finance policies. 31 May 2023. ESMA30-1668416927-2498; ESMA Final Report on Greenwashing Response to the European Commission's request for input on "greenwashing risks and the supervision of sustainable finance policies, 4 June 2024 ESMA36-287652198-2699 (hereafter: ESMA Greenwashing Report).

[127] EIOPA Advice to the European Commission on Greenwashing – Progress Report. EIOPA-BoS-23/157. 01 June 2023; EIOPA Advice to the European Commission on greenwashing risks and the supervision of sustainable finance policies. Final Report. 4 June 2024. EIOPA-BoS-24-159 (hereafter: EIOPA Greenwashing Report).

[128] ESMA attributes the low number of reported cases to few complaints reaching the NCAs, limited financial literacy, constraints on NCAs' resources and expertise for detection, and NCAs' difficulties to access good quality data, etc. See ESMA Greenwashing Report, p. 3 (Executive Summary no. 4, Key Findings).

[129] The EIOPA reports that "providers reported generally complying with sustainability-related requirements, EIOPA sees room for improvement". EIOPA Greenwashing Report p. 4 (Executive Summary).

[130] EBA Greenwashing Report, pp. 12-15, paras. 19-24.

[131] Ibid, p. 16, para. 26. The EBA also reported that "Seven CAs have identified occurrences of actual or potential greenwashing since November 2022. Approximately one third of respondents were able to provide at least one example of an actual greenwashing practice

This suggests that there may be room for improvement in the NCAs reporting systems, as well as in public awareness of greenwashing risks.

The ESAs also **offer different views** on greenwashing "detection". ESMA, the authority with broader direct supervisory competences states that it has increased its analytical efforts, to also help NCAs build their own, tools, including natural language processing (NLP) and web-scrapping techniques, while the EBA refers to some NCAs' intention to build such systems, and recommends them[132] (but makes no reference to its use of them) and the EIOPA makes no reference to them.

The methodology for identifying greenwashing "dimensions" is outlined more clearly in the ESMA Progress Report,[133] based on a review of the literature. Given its comprehensive nature, a summary is provided in the following table:

Table 4: ESMA's dimensions of greenwashing

Dimension	Parameters for each dimension		
Roles in greenwashing	Trigger	Spreader	Receiver
Topics about which the claim is communicated	Governance and resources • Board and senior management role • ESG resources and expertise	ESG Strategy • ESG strategy, objectives and characteristics • Management policies • ESG credentials • Stakeholder engagement	Sustainability metrics and targets • ESG performance to date (ESG results & impact) • Pledges about future ESG performance: ESG targets
Qualities through which the claim is misleading	Misleading through provision of information (6 qualities) • Empty claims • Inconsistency • Irrelevance • Outright lie • Suggestive non-textual imagery and sounds • Suggestive use of ESG-related terminology	Misleading through omission of information (6 qualities) • Cherry-picking • Omission or lack of disclosure • Vagueness/ambiguity, lack of clarity • Lack of fair/meaningful comparisons, thresholds and/or underlying assumptions • No proof • Outdated information	
Channels through which claim is communicated	**Regulatory information** (prospectuses, financial statements, sustainability disclosures) **marketing materials** (website, social media, investor presentations) **ratings and benchmarks & labels, intermediary/advice** information, **product information**, and **voluntary reporting** (falling outside previous categories)		

Source: ESMA Progress Report on Greenwashing (Figure 2).

occurred since the first survey, while more than two thirds of respondents stated that they could not provide any example". Ibid p. 16, para. 27.

[132] EBA Greenwashing Report, p. 52, para. 151, and Box 6 (Recommendations to Supervisors – SUP – 5), pp. 59-60.

[133] Figure 2. Dimensions used to analyse Greenwashing Risks. ESMA Progress Report on Greenwashing, p. 18.

Using this methodology, the ESMA's own assessment in the Progress Report identifies the following "high-risk areas" for investment managers.

Table 5: Greenwashing high-risk areas for investment managers

High-risk area	Explanation / Examples
Impact	• Implying an ESG metric results from a strategy when it results from intrinsic features of investable universe [Climate-focused fund claiming retail investors could achieve calculable positive effect on CO2 footprint depending on investment when in reality achieving quantifiable contributions to ecological goals was only a secondary objective of fund] • Claim of low-carbon strategy by high-carbon emissions fund
Engagement	• Unsubstantiated (empty) engagement strategies or no details on engagement
Governance	• Having policies requiring fund managers/analysts to consider ESG risk, but no system to track compliance with policy
Strategy	• Vague, exaggerated or incomplete statements (omission). SFDR prospectuses lack of commitment and specificity regarding the sustainable characteristics or objectives of SFDR financial products [The fund aims at contributing to [one/more sustainable objectives]
Credentials	• Reference to excessive number of sustainable objectives/characteristics without specified commitment

Source: Authors' own elaboration, based on a summary of ESMA's high-risk areas.

The **EBA Progress Report** focuses instead the stakeholders' views on the sustainability-related claims (1) more prone to greenwashing, and (2) with the highest harm (impact). Claims on (i) pledges about future ESG performance; (ii) engagement with stakeholders, (iii) ESG performance to date; (iv) ESG qualifications/labels and (v) ESG strategy, objectives, characteristics, (vi) or management policies are rated as the most "prone" and "harmful".[134] This is largely coincident with ESMA's identification of claims on "impact" (both past and future), "engagement", "governance", "strategy" or "credentials".

The EIOPA Final Report (the Progress Report does not detail this aspect), based on stakeholders' views on its Call for Evidence (CfE) classifies the likelihood of greenwashing risk in the different stages of the insurance and pension lifecycle (where marketing and sales are predominant), but instead of "pointing fingers" the EIOPA provides stylised examples of misleading claims (bad) and good practices.[135]

In summary, **it is noticeable that, whereas the three ESAs point at very similar problems, they differ in their approach and methodology.** The EBA follows an "explanatory", or "compilatory" approach, where it gathers evidence from CAs and stakeholders, to spot trends, and then relies on their own previous instruments and work (e.g., ESAs guidelines on product oversight, remuneration, complaints-handling, or EIOPA's 2023 Opinion) to address the problem, rather than developing its own distinct conceptual approach. The EIOPA's approach is more ambitious, perhaps, but "educational",

[134] EBA Progress Report, p. 17, Table 1. Not all claims are rated as equally prone to greenwashing, or as having "high/very high impact" by an equally high number of respondents. Pledges on future ESG performance are rated as "prone" by 55,89%, and as "high/very high impact by 60,29% of respondents, claims of "engagement" are rated as "prone" by 55,15% and as "high impact" by 41,48%, ESG performance (including impact claims) are rated "prone" by 50,73%, and as "high impact" by 59,56%, etc.

[135] EIOPA Greenwashing Report, pp. 12-18. The examples identify the reasons why they are misleading, in light of the EIOPA's four principles, and include the following disclaimer: "The explanations of why a claim is misleading are for illustrative purposes. They should not be understood as representing EIOPA's supervisory assessments".

focused on building a distinct, principles-based conceptual framework, through its Opinion, and then teach the industry the difference between good and bad practices. The ESMA follows a "prescriptive" approach, which departs from its "quasi-regulatory" guidelines on "fund names", a rigorous conceptual methodology, and a clear identification of "good" practices, and of "high-risk" areas, and a more hands-on approach on supervisory practices, suggesting clear actions to NCAs.

Although the EU tends to lead efforts in this area, it is also important to draw **comparisons at a global level**. A 2023 Report by the IOSCO[136] relates the practices by the ESAs (notably the ESMA) and EU jurisdictions (e.g., France, Germany, the Netherlands, Italy, or Spain) as well as non-EU jurisdictions, such as the UK, Switzerland, Canada (both Quebec and Ontario) Australia, Singapore, Hong Kong, Morocco, India, Japan or the US. Although the EU is well ahead in many respects (e.g., the regulatory framework[137]) it can learn from some jurisdictions on other aspects (e.g., technological tools[138]).

This richness of approaches to greenwashing contrasts with the lack of attention dedicated to "green bleaching", which arises when financial market participants choose not to claim ESG features of their products in order to avoid extra regulation and potential legal risks. This is striking, considering that the Securities Markets Stakeholders' Group (SMSG) has warned about this for some time,[139] and has insisted upon it in the Call for Evidence on Greenwashing.[140] As seen below, there seems to be some worrisome evidence of this,[141] which is why further efforts should be dedicated to its identification and assessment.

4.3. Sustainability "negative" criteria (what sustainability is not)

4.3.1. Sustainability "negative" criteria: do not significant harm (DNSH) and principal adverse impacts (PAIs) in context

There is a problematic coexistence between "sustainable investments" negative criteria in the Taxonomy and SFDR. As pointed out above (section 2.1.), an investment is not "**SFDR sustainable**" if it contributes to an environmental objective but it does significant harm to a social objective (or vice-versa), while an investment can be "**TR sustainable**" if it "substantially contributes" to an environmental objective, while it does no significant harm to *another* environmental objective, raising the question of what happens if it harms, e.g., a social objective.

To close this loophole **the TR also requires a TR-sustainable investment to respect "minimum safeguards"** (Article 18 TR), which encompasses both (i) due diligence and remedy procedures that comply with the Organisation for Economic Cooperation and Development (OECD) Guidelines on Multinational Enterprises (MNEs) and the UN Principles on Businesses and Human Rights (Article 18 (1) TR); and (ii) **the SFDR's** "do not significant harm" (Article 18 (2) TR), based on SFDR methodologies for Principal Adverse Indicators (PAIs) for social and employee matters, respect for human rights, anti-

[136] IOSCO Supervisory Practices to Address Greenwashing Final Report FR12/23. December 2023 (IOSCO Greenwashing Report).

[137] The IOSCO Report, within Section 3.1. on Asset managers, dedicates a specific subsection (3.1.1.) to discuss the EU framework.

[138] IOSCO Greenwashing Report section 4.1.2., p. 39.

[139] SMSG advice to the ESMA Consultation Paper on Guidelines on certain aspects of the MiFID II suitability requirements. 3 May 2022 ESMA22-106-4032.

[140] SMSG advice to ESMA on the ESAs' Call for Evidence on Greenwashing. 18 January 2023. ESMA22-106-4384.

[141] Infra 5.1.

corruption and anti-bribery matters. Thus, Taxonomy-aligned investments automatically qualify as SFDR-sustainable investments.[142]

The TR cross-reference to the SFDR enhances consistency: if the SFDR's DNSH criteria change, the TR minimum safeguards will adjust accordingly. However, **the result is overly complicated. "Do not significant harm" means different things in the TR and the SFDR, and the framework could be streamlined.** One option would be to pick a single concept ("minimum safeguards" or DNSH) and base it, e.g., on the UN and OECD frameworks. The combination of the two frameworks provides the "core" of both the TR "minimum safeguards", on one hand, and the SFDR DNSH *and* "good governance practices"[143] on the other hand. The SFDR's PAIs mainly add to the OECD and UN Frameworks the exposure to controversial weapons.[144]

Table 6: Negative sustainability criteria under the Taxonomy Regulation and the SFDR

<table>
<tr><th>Exclusions</th><th colspan="2">Taxonomy Regulation</th><th colspan="2">SFDR</th></tr>
<tr><td>Environmental harm</td><td colspan="2">TR DNSH</td><td colspan="2">DNSH (environmental PAIs)</td></tr>
<tr><td>FF.RR. + social harm/impact</td><td rowspan="3">Minimum safeguards</td><td>OECD, UN (FF.RR., social)</td><td rowspan="2">DNSH (social, FF.RR.)</td><td rowspan="2">= OECD, UN + controversial weapons</td></tr>
<tr><td rowspan="2">Governance practices</td><td>SFDR DNSH</td></tr>
<tr><td>OECD, UN (governance)</td><td colspan="2">Good governance practices</td></tr>
</table>

Source: Authors' own elaboration.

Another, potentially greater problem is that **the Taxonomy is a *classificatory* regulation,** i.e., an investment is "sustainable", or Taxonomy-aligned, or it is not, while **the SFDR is a *disclosure* regulation**, i.e., FMPs must *explain* what PAIs are considered and how, including their quantification (Article 7 SFDR). The Commission has clarified that "consideration" means "information" *and* "mitigation", with time horizons[145] but this still leaves much **leeway** on **what is sustainable, what PAIs are considered, and how**.[146] This creates much uncertainty for the industry. **A large majority of FMPs and FAs encounter methodological challenges when trying to link the PAI indicators at entity-level with the product-level DNSH, and when to consider such PAIs "material"**.[147]

In addition, the interplay between SFDR and Benchmarks Regulation is not good either. Indexes can be used as reference for the selection of investments,[148] e.g., a Climate Transition Benchmark (CTB)

[142] Commission Notice on the interpretation and implementation of certain legal provisions of the EU Taxonomy Regulation and links to the Sustainable Finance Disclosure Regulation (2023/C 211/01). The PAIs methodology is included in Table 1 of Annex I of SFDR CDR 2022/1288.

[143] The four ítems of "good governance" under Article 28 SFDR CDR 2022/1288 (sound management structures, employee relations, remuneration of staff and tax compliance) are covered by the compliance with the OECD MNEs Guidelines, and the UN Principles, which are "minimum safeguards" under Article 18 (1) TR. Commission Notice on the interpretation and implementation of certain legal provisions of the EU Taxonomy Regulation and links to the Sustainable Finance Disclosure Regulation (2023/C 211/01), p. 5 (hereafter: Commission Notice 2023/C 211).

[144] "Exposure to controversial weapons" is PA indicator, an item in Table 1, Annex I SFDR CDR 2022/1288, but not part of UN or OECD frameworks.

[145] ESAs SFDR Q&A. Section IV PAI Disclosures, Q 3.

[146] See, e.g., CDR 2022/1288, Annex II (Article 8 products) and Annex III (Article 9 products) both include the question "Does this financial product consider principal adverse impacts on sustainability factors?".

[147] Commission Summary of responses to Public Consultation and Targeted Consultation, no. 4.1.

[148] Articles 8 and 9 SFDR.

or Paris-Aligned Benchmark (PAB).[149] These have their own criteria for *excluding* companies. For CTBs "the activities relating to the underlying assets do not significantly harm other ESG objectives,"[150] and for PABs, the Commission must adopt delegated acts for *"the sectors to be excluded because they do not have measurable carbon emission reduction targets with specific deadlines that are aligned with the objectives of the Paris Agreement".*[151]

The Commission's Benchmarks Level 2 (CDR 2020/1818[152]) excludes companies from indexes using two types of cumulative criteria based on: (1) the company's activity and credentials (Article 12 (1)), and (2) the company's causing "significant harm" to TR *environmental* objectives (Article 12 (2)). The DNSH criterion (Article 12 (2) CDR 2020/1818 2) is aligned with the TR.

However, the **exclusions** under Article 12 (1) CDR 2020/1818 **differ** from the TR's minimum safeguards and the SFDR's PAIs. They exclude from both PABs and CTBs companies (a) involved in any activities related to controversial weapons, (b) tobacco producers, and (c) companies in breach of UN Global Compact or OECD Guidelines (exclusions (a) – (c) or "**weapons, tobacco and breach of standards**" exclusion). Involvement with controversial weapons is a PAI under the SFDR CDR 2022/1288 but that does not "exclude" an investment,[153] while tobacco production is not even a PAI under the SFDR.

Furthermore, Paris-Aligned Benchmarks (PABs) also have the "**carbon exclusions**", i.e., PABs (not CTBs)[154] exclude companies deriving certain revenue from (d) coal (1%), (e) oil (10%), (f) gas (50%), or (g) electricity with certain GHG-intensity (100 g CO_2 e/kWh).[155] Using these percentages to *exclude* investments does not clearly derive from the Taxonomy Delegated Acts. In those Acts, a GHG intensity above 100 CO_2 e/kWh is a "positive" threshold for a *substantial contribution* to climate change mitigation,[156] not a "negative threshold" for "causing harm". This "layered exclusion" system is summarized in the following table.

[149] Articles 19a, 19b and 19c Benchmarks Regulation.

[150] Article 19b Benchmarks Regulation.

[151] Article 19c Benchmarks Regulation.

[152] Commission Delegated Regulation 2020/1818, of 17 July 2020 supplementing Regulation (EU) 2016/1011 of the European Parliament and of the Council as regards minimum standards for EU Climate Transition Benchmarks and EU Paris-aligned Benchmarks (hereafter: Benchmarks CDR 2020/1818).

[153] The PAI is defined as "Share of investments in investee companies involved in the manufacture or selling of controversial weapons". See Annex I Table 1, CDR 2022/1288 (Indicators for Social, Employee, Human Rights, Anti-Corruption and Anti-Bribery Matters, no. 14).

[154] Article 12 (1) (d) – (g) CDR 2020/1818. CTBs also had more flexibility in the form of a phase-in period until 31 December 2022.

[155] Article 10 (2) by reference to Article 12 (1) (a) – (c) and (2) Benchmarks CDR 2020/1818.

[156] See Commission Delegated Regulation (CDR) 2021/2139 of 4 June 2021 supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council by establishing the technical screening criteria for determining the conditions under which an economic activity qualifies as contributing substantially to climate change mitigation or climate change adaptation and for determining whether that economic activity causes no significant harm to any of the other environmental objectives. It is the reference figure in the technical screening criteria of "substantial contribution to climate change mitigation". See, e.g., no. 3.8. (Manufacture of aluminium), 3.12. (manufacture of soda ash), or 4.5. (electricity generation using hydropower), among many.

Table 7: Negative criteria in the Taxonomy, SFDR and Benchmarks Regulation

<table>
<tr><th rowspan="2">Exclusions</th><th colspan="2" rowspan="2">Taxonomy Regulation</th><th colspan="2" rowspan="2">SFDR</th><th colspan="2">Benchmark Regulation</th></tr>
<tr><th>CTBs</th><th>PABs</th></tr>
<tr><td rowspan="2">Environmental harm</td><td colspan="2" rowspan="2">TR DNSH</td><td colspan="2" rowspan="2">DNSH (environmental PAIs)</td><td rowspan="2">TR DNSH</td><td>TR DNSH</td></tr>
<tr><td>Specific exlusions: coal, oil, gas, GHG intensity</td></tr>
<tr><td rowspan="2">FF.RR. + social harm/impact</td><td rowspan="3">Minimum safeguards</td><td>OECD, UN (FF.RR., social)</td><td rowspan="2">DNSH (social, FF.RR.)</td><td rowspan="2">= OECD, UN + controversial weapons</td><td colspan="2">OECD, UN (FF.RR., social)</td></tr>
<tr><td>SFDR DNSH</td><td colspan="2">Specific exclusions: controversial weapons, tobacco</td></tr>
<tr><td>Governance practices</td><td>OECD, UN (governance)</td><td colspan="2">Good governance practices</td><td colspan="2">OECD, UN (governance)</td></tr>
</table>

Source: Authors' own elaboration.

Although each specific exclusion may be individually justified, EU legislators must consider whether the gain in precision justifies the **increase in complexity**. The idea that "EU Climate Transition Benchmark' and 'EU Paris-aligned Benchmark' are reliable and easy for investors across the Union to recognise"[157] does not seem realistic.

Another problem is that the **Benchmarks Regulation's** approach is to "**exclude and weigh**", i.e., benchmark administrators (i) exclude certain companies from the index (see above) and then (ii) assign weights to the companies based on methodologies that must take into account a decarbonisation trajectory, and a baseline reduction of GHG intensity or GHG absolute emissions of the index with respect to the general investable universe.[158] The **SFDR**, as already discussed, follows an "**identify and disclose**" approach, based on DNSH/PAIs and good governance. Thus, the indexes exclusions and weights may not suffice to satisfy the requirement to report on PAIs.

ESMA's recent guidelines on funds' names using ESG or sustainability-related terms,[159] try to align the SFDR and the Benchmarks frameworks via interpretation. This is laudable. Funds using "transition-, social- or governance-related terms" must use the exclusions (a) – (c) or "**weapons, tobacco and breach of standards**" exclusions, typical of Climate-Transition Benchmarks (CTBs), while funds using "environmental- or impact-related", or "sustainability-related" terms, must use these plus the "carbon exclusions", i.e., as Paris-Aligned Benchmarks (PABs).

The **ESMA's Guidelines may help with the "labeling" problem** of certain types of funds. However, they do **not** solve **the "reporting" problem**, i.e., the information produced by benchmark administrators may be insufficient to ensure that FMPs/FAs comply with SFDR's reporting standards on PAIs/DNSH. As the next section illustrates, this is a general challenge of the "information pipeline", which encompasses both the disclosures by corporates, and by benchmark administrators.

157 Recital (16) Benchmarks Regulation.

158 Articles 4, 7, 8, 9 and 11 Benchmarks CDR 2020/1818. The baseline reduction is 30% for CTBs, and 50% for PABs.

159 ESMA Guidelines on funds' names.

4.3.2. "Adverse impact", and consistency across the information pipeline: CSRD (and CSDDD), Benchmarks Regulation

The information pipeline, from corporates and indexes to FMPs and FAs needs to work better. The CSRD is the main legislative text on sustainability reporting by corporates, and thus constitutes the main source of information for FMPs and FAs when complying with their SFDR obligations.

The CSRD, **by adopting the "double materiality" perspective**, requires firms to report *"both on the impacts of the activities of the undertaking on people and the environment, and on how sustainability matters affect the undertaking"*.[160] Thus, entities subject to the CSRD are required to "include in the management report information necessary to understand the undertaking's impacts on sustainability matters" and *"the principal actual or potential adverse impacts connected with the undertaking's own operations and with its value chain"*.[161]

The CSRD (Levels 1 and 2) seeks to ensure that the information pipeline works, i.e., that the information provided by corporates helps FMPs and FAs fulfil their disclosure requirements under the SFDR. There is a mandate to the Commission to take into account this factor.[162] The European Sustainability Reporting Standards (ESRS) adopted via the Level 2 text (CDR 2023/2772), try to abide by that mandate, by requiring corporates to report on specific impacts of their activities on sustainability factors,[163] and also by cross-referencing the SFDR, pointing where specific data points by corporates provide the basis for the SFDR's PAIs.[164]

However, some difficulties remain. **Determining what is "material" requires some exercise of judgment**, in both corporates subject to the CSRD, and FMPs/FAs subject to the SFDR, and they may differ in their assessment of such materiality. Furthermore, **CSRD** sustainability reporting requirements are **extensive**, and thus **costly** to produce for corporates, which means that corporates may lack the incentive, and/or resources to provide the information with a level of detail that FMPs or FAs need to comply with their reporting of PAIs, or the format and organisation of the information may make it difficult for FMPs and FAs to handle it. **Entities subject to the SFDR tend to find that there is room for streamlining and aligning CSRD and SFDR definitions and terminology, and align the assessment of materiality at the level of corporates and FMPs**, i.e., either FMPs should be allowed to consider non-material the same items that the corporates they invest in consider non-material, or corporates should be incentivised to produce the information FMPs need, or required to consider all data points needed by the FMPs as material.[165] On top of this, **some entities fall outside the scope of the CSRD.** Thus, **the CSRD cannot entirely solve the FMPs' data problem.**

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[160] CSRD recital (29).

[161] Article 19a (1) and (2) (f) (ii) Accounting Directive, as amended by the CSRD.

[162] Article 29b (1) para. 2nd and (5) (b) of the Accounting Directive, as amended by the CSRD.

[163] Commission Delegated Regulation 2023/2772 of 31 July 2023 supplementing Directive 2013/34/EU of the European Parliament and of the Council as regards sustainability reporting standards (hereafter: CDR 2023/2772), recitals (1), (2), ESRS 1 (General Requirements) nos. 3.3. (Double materiality), 3.4. (Impact materiality).

[164] By way of example, ESRS 2 (General Disclosures) GOV – 1 para. 13 (board's gender diversity), fn. (13), or GOV – 4 para. 32 (due diligence) cross-refers to SFDR CDR 2022/1288 Annex I Table 1 indicator 13, Table III indicator 10; ESRS 2, SBM – 1 para. 40 (d) (i) (undertaking's activity in the fossil fuel sector) (ii) (chemicals production), or (iii) controversial weapons) CDR 2023/2772, cross-refer to SFDR CDR 2022/1288 Table I indicator 4, Table II indicator 9, or Table I, indicator 14, and so on.

[165] Commission Summary of responses to Public Consultation and Targeted Consultation, no. 4.2., pp. 5-6.

In addition to this, it is important to consider the implications of the recently adopted Corporate Sustainability Due Diligence Directive (CSDDD).[166] The CSDDD provides for a mandatory requirement among corporates to take (due diligence) measures to effectively address "adverse impacts" (environmental and human rights) in their operations, as well as those of their subsidiaries and business partners in the 'chain of activities'[167] including by[168] integrating due diligence in risk management,[169] having mechanisms in place to identify, assess, prioritise,[170] prevent and mitigate,[171] and remedy[172] adverse impacts. Although the CSDDD is not a reporting or disclosure text, **the due diligence systems it requires, once in place, will make it likelier to detect "adverse impacts" that may be material.**

Nevertheless, the aggregate effect of all these rules (CSRD, CSDDD, SFDR) is that the **information produced is too complex**, and still **has gaps**. Some large operators have developed proprietary systems (e.g., Blackrock's Aladdin, BNP's Clover, etc.) However, processing the information and filling the gaps is **beyond the capacity of many intermediaries**, which must rely on **third-party data services providers** (e.g., Morningstar Sustainalytics, MSCI and the like) for data and methodologies. Third party providers operate in a market that is increasingly concentrated,[173] and while ESG rating providers, are regulated,[174] other data-related services are not. Authorities should pay attention to this, to find ways to reduce dependency on third-party providers, if necessary, by taking a more active role in the development of the necessary tools.

4.4. Sustainability "positive" criteria (what sustainability is… maybe)

4.4.1. "Sustainability" vagueness; and the challenges to accommodate "impact"

(1) Even if an asset is not excluded under one of the criteria discussed above, it still needs to fulfil a "positive" condition to be "sustainable", which, under the SFDR Article 2 (17) means that it:

> "contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities…"

[166] For the adoption by the Council, see https://www.consilium.europa.eu/en/press/press-releases/2024/05/24/corporate-sustainability-due-diligence-council-gives-its-final-approval/. The numbering of articles is taken from the text adopted by the Parliament on April 24 (provisions may be renumbered in the Official Journal version).

[167] Article 1 (1) CSDDD.

[168] Article 5 CSDDD.

[169] Article 7 CSDDD.

[170] Articles 8 and 9 CSDDD.

[171] Articles 10 and 11 CSDDD.

[172] Article 12 CSDDD.

[173] IOSCO Environmental, Social and Governance (ESG) Ratings and Data Products Providers Final Report, FR 09/21, November 2021, p. 3.

[174] Regulation (EU) 2024/… of the European Parliament and of the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities, and amending Regulation (EU) 2019/2088. See David Ramos Muñoz; Agnieszka Smolenska "The Governance of ESG Ratings and Benchmarks (Infomediaries) as Gatekeepers: Exit, Voice and Coercion" EBI Working Paper series 2023 – no. 149 (forthcoming in European C*ompany and Financial Law Review* – 2024); Matteo Gargantini M Michele Siri, Information Intermediaries and Sustainability: The Case of ESG Ratings and Benchmarks, forthcoming in *The Cambridge Handbook of EU Sustainable Finance: Regulation, Supervision and Governance* (ed. Kern Alexander, Matteo Gargantini, Michele Siri) - Cambridge University Press - 2024.

Taxonomy-aligned investments qualify as "sustainable" under the SFDR.[175] The problem arises when going beyond the Taxonomy. If an FMP invests in a funding instrument not specifying the use of proceeds, e.g., general equity or debt, *"the FMP would still need to check additional elements under the SFDR in order to consider the whole investment in that undertaking as sustainable investment. This means that the FMP would still need to: (i)* ***check whether the rest of the economic activities*** *of the undertaking* ***comply with the environmental elements of*** *the SFDR* ***DNSH principle****; and (ii)* ***assess whether she/he considers the contribution to the environmental objective sufficient****".*[176]

However, the SFDR does not set minimum requirements for these key parameters.[177] For products with a sustainable investment objective (Article 9 "dark green" products) FMPs must include in pre-contractual and periodic information a description of the sustainability objective, an explanation of how it is to be attained (if a benchmark is used, an indication of whether it is a CTB or PAB, and where the methodology for its calculation can be found[178]). For products that "promote environmental or social characteristics" (Article 8 "light green" products) they only must disclose the characteristics (including whether a benchmark has been designated) the indicators used to measure the attainment of the characteristics, and, if the product makes any sustainable investments, the objectives of such investments. The TR incorporated a requirement to disclose the asset allocation to environmentally sustainable economic activities,[179]and CDR 2022/1288 requires disclosure of the investment strategy, and the asset allocation, based on a specific formula.[180]

It is doubtful whether actual investors distinguish well between "Article 8" and "Article 9" products (or appreciate the difference), understand asset allocation, or, more importantly, discern whether the "Article 9", or "Article 8" are aligned with their preferences and represent a meaningful difference with general Article 6 products. To ask them to distinguish between Taxonomy-aligned-sustainable and SFDR-sustainable seems absurd. Asked whether a financial product can "promote" carbon emissions reduction as an "environmental characteristic", as opposed to having it as an "objective" (i.e., Article 8, instead of Article 9) the Commission insists that investors should not be misled,[181] but **the precondition for this is that they understand the difference between an "objective" and a "characteristic"**. Something that, in the face of the existing ambiguities in the legal framework and individual preferences, may result in the end in a cabalistic future telling exercise.

The **ESMA's guidelines on fund names try to clarify the minimum conditions that a fund must fulfil to carry certain names**.[182] However, these minimum conditions are not based on an express legal provision, or on a definition of "sustainable investment", nor can the ESMA provide one, without an express legal mandate. Thus, it is not surprising that **the ESAs have jointly called for a reform of the SFDR that defines "sustainable investment" more precisely**, by relying on the environmental Taxonomy for environmentally sustainable investments and defines "socially" sustainable investments

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[175] Supra 4.3.1.

[176] Commission Notice 2023/C 211, p. 5.

[177] ESAs SFDR Q&A Section II. "Definition of Sustainable Investment" Q 2.

[178] CDR 2022/1288, Annex III.

[179] Articles 5 and 6 TR.

[180] Article 17 CDR 2022/1288.

[181] SFDR Q&A, Section V (Financial product disclosures) Q8. "marketing documents should not lead investors into believing that the product pursues sustainable investment, where the promotion of carbon emissions reductions is only a mere characteristic of the product's investment strategy" (Answer provided by the European Commission on the interpretation of the SFDR, published on 6 April 2023).

[182] ESMA Guidelines on funds' names. See also infra 4.4.2.

in a similarly precise way, awaiting the Social Taxonomy,[183] which can be a long wait[184] indeed. These concerns are warranted.

The incentives for the use of benchmarks are also problematic. As a disclosure regulation, "neutral" in terms of product design,[185] the SFDR does not prescribe the use of Paris-Aligned Benchmarks ('PAB') or Climate Transition Benchmarks ('CTB') nor the use of any other specific type of index. Products that passively track indexes, for instance, must explain the extent to which they comply with the Benchmarks Regulation CDR,[186] and, if no index is tracked, it must provide a specific explanation.[187] **Thus, it is less costly to passively track an index, regardless of whether the objectives are less ambitious or more ambitious than the index**.

(2) A second consideration from the perspective of the SFDR's "positive" criteria is the idea of "**impact**". The SFDR's complex mechanism not only tries to make it possible for FMPs and FAs to report on sustainability risks, and "adverse impacts", but to also promote investments in funds that pursue sustainable objectives (Article 9 funds). **Within this asset class the subset of "impact" investing has attracted much attention in recent times.** Busch et al. point that the sustainable finance market has evolved in stages, starting with "ethical" investments (i.e., mostly avoiding "unethical" investments), continuing with a "mainstreaming" of sustainability in the market, primarily through risk management, and then evolving towards "impact" investment, defined as investment seeking to make real-world changes (in environmental or social factors[188]). In light of this, the authors distinguish, within the universe of "sustainable investments", between (i) ESG-screened investments), (ii) ESG-managed investments, (iii) impact-aligned investments and (iv) impact-generating investments.[189]

It is also important to distinguish between (i) a company's impact, and (ii) an investor's impact.[190] **Companies** have the real-world impact through their activities, and although this is hard to measure there have been important developments in measurement and accountability, such as the Impact-Weighted Accounts Initiative (IWAI[191]), or the Global Impact Investing Network (GIIN's, IRIS+[192]). **Investors** do not have impact by "owning" companies, but by choosing those which have a positive impact and help them ***grow*** or by choosing companies with potential for improvement, and helping them ***improve*** in E, S, or G criteria through voting and engagement,[193] i.e., by "buying" or "creating"

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183 Joint ESAs Opinion on the SFDR "Summary of Recommendations" letter (e), p. 5, and no. 2.2. (i), p. 8.

184 As the Platform on Sustainable Finance itself acknowledged, for starters science cannot play the same role in a social taxonomy as it played in the environmental taxonomy. Final Report on Social Taxonomy Platform on Sustainable Finance February 2022, p. 30. This inevitably renders the process more politically contentious.

185 Supra 4.1.

186 Including 2020/1818, as required by CDR 2022/1288. See SFDR Q&A Section V (Financial product disclosures) Q7.

187 As required by SFDR Article 9 (3) 2nd para. See SFDR Q&A Section V (Financial product disclosures) Q9.

188 Timo Busch, Peter Bruce-Clark, Jeroen Derwall, Robert Eccles, Tessa Hebb, Andreas Hoepner, Christian Klein, Philipp Krueger, Falko Paetzold, Bert Scholtens, Olaf Weber "Impact investments: a call for (re)orientation *Springer Nature Business and Economics* 1:33 (2021).

189 Busch et al. (2021), 7.

190 Julian F. Koelbel, Florian Heeb, Falko Paetzold, Timo Busch "Can sustainable investing save the world? Reviewing the mechanisms of investor impact," Organization & Environment 33:4 (2020) pp. 554–574; F. Heeb, J. Koelbel "The investor's guide to impact: evidence-based advice for investors who want to change the world," The Center for Sustainable Finance and Private Wealth (CSP), University of Zurich (2020).

191 https://impacteconomyfoundation.org/impactweightedaccountsframework/. See also Ronald Cohen, George Serafeim "How to Measure a Company's Real Impact" *Harvard Business Review* September 3 (2020).

192 The Global Impact Investing Network. See at https://thegiin.org/.

193 Julian F. Koelbel, Florian Heeb, Falko Paetzold, Timo Busch (2020).

impact.[194] Accepted methodologies to measure investor impact include the Impact Management Project,[195] or the G7 Impact Taskforce Typology (ITF[196]).

"Impact investing" lacks a specific place in the SFDR. Articles 8 or 9 can both accommodate different types of impact funds. However, they are drafted with a different framework in mind. FMPs must comply with Article 8 and 9 independently of whether they have an impact strategy.[197] References to the disclosure of "impact per euro invested" in periodic reports,[198] or "engagement policies"[199] are too broad to signal "impact investment" as a subtype. Thus, Article 8 and 9 funds can accommodate funds with very different levels of ambition.

In contrast, **the Financial Conduct Authority (FCA) in the UK, which openly uses a "labeling" approach, distinguishes** between "**sustainability mixed goals**", "**sustainability focus**", "**sustainability improvers**" and "**sustainability impact**" labels.[200] The latter is for products investing in solutions to problems affecting people or the planet (often in underserved markets or to address observed market failures) to achieve real-world impact, i.e., with the explicit objective to achieve a positive, measurable contribution to sustainable outcomes.[201]

4.4.2. The ESMA "names guidelines": positive, negative and measurable elements

Considering all the difficulties described in the previous point, ESMA's recent guidelines on funds' names using ESG or sustainability-related terms try to provide some clarity.[202]

The ESMA's Guidelines distinguish between: (i) "**transition**-, **social**- and **governance**-related terms"; (ii) "**environmental**- or **impact**-related terms"; and (iii) "**sustainability**-related terms".

Then, the Guidelines provide some (1) common criteria for all three types of funds, and (2) distinct criteria for specific types of funds.

1. Among the commonalities, the three types of funds must:

> *"meet an 80% threshold linked to the proportion of investments used to meet environmental or social characteristic or sustainable investment objectives in accordance with the binding elements of the investment strategy, which are to be disclosed in Annexes II and III of CDR (EU) 2022/1288;"*

Although the 80% is common for all types of funds, it will apply differently, for each fund, since the key are the "binding elements" of the investment strategy, which will differ between funds.

- all funds must also apply the "**weapons, tobacco and breach of standards"** exclusions applicable to Climate Transition Benchmarks (CTBs), i.e., those involved with controversial weapons or tobacco manufacturing or marketing, or in breach of UN/OECD Guidelines; and,

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[194] ESMA Progress Report on Greenwashing, p. 41, paras. 98-99.

[195] The Impact Management Platform. See at https://impactmanagementproject.com/.

[196] Impact Taskforce (ITF) Financing a better world requires impact transparency, integrity and harmonisation (2021). Available at: https://www.impact-taskforce.com/media/io5ntb41/workstream-a-report.pdf.

[197] ESMA Progress Report on Greenwashing, p. 41, para. 99.

[198] Article 64 (2) (a) SFDR CDR 2022/1288.

[199] Article 8 and Table 1 of Annex I (in general) , and articles 24 (k) and 35 (Article 8 products), and 37 (k) and 48 (Article 9 products) SFDR CDR 2022/1288.

[200] FCA Sustainability Disclosure Requirements (SDR) and investment labels. Policy statement PS 23/16.

[201] FCA Sustainability Disclosure Requirements (SDR) and investment labels Policy Statement PS 23/16, p. 41.

[202] ESMA Guidelines on funds' names.

- funds with "environmental- or impact-related terms" or "sustainability-related terms" must also apply the "**carbon exclusions**" of Paris-Aligned Benchmarks (PABs).

2. Among the distinct features:

   - funds with "sustainability-related terms" must *"commit to invest meaningfully in sustainable investments referred to in Article 2(17) of the SFDR"*.
   - funds designating an index as a reference benchmark should only use the corresponding terms (transition/social/governance, environmental/impact, sustainability) if the fund fulfils the guidance criteria for specific investments.
   - funds using "transition-" or "impact"-related terms in their names should also ensure that investments used to meet the threshold are in a *measurable* path to transition or generate a *measurable* impact.

Several features of the ESMA's guidelines stand out:

1. First, on the "positive" or "affirmative" side, the more salient feature is the 80% threshold:

   - The threshold is a very precise measure, but its legal basis is not in the SFDR, which is a disclosure-based legal text, but in the recently amended provisions in UCITS, AIFMD, which require the ESMA to develop guidelines to ensure that the information on funds is "fair, clear and not misleading", i.e., **no legal text includes an express provision suggesting a concrete, minimum level**;[203]
   - **It mirrors the recently amended US - Securities and Exchange Commission (SEC) "Fund Names" Rule,[204] and goes beyond, e.g., the 70% threshold by the FCA in the UK, applicable to "sustainable focus", "sustainable improvers" and "sustainable impact" funds;**[205]
   - It was complemented initially (in the draft guidelines) with a 50% threshold in "sustainable investments" under Article 2 (17) SFDR both for funds with "sustainability-related terms" and "impact-related" terms. The final version dropped this 50% threshold.

2. Second, on the "negative" side of exclusions: funds with "transition" names do not have to apply "carbon exclusions", but "impact" funds do. **This means that the ESMA is embracing a narrower conception of impact, along the lines of the UK FCA, which does not include strategies of "creating" impact through engagement in carbon-intensive companies**.

3. Third, the key for transition or impact funds is "**measurability**", but **the Guidelines are relatively open as to how this can be achieved**. The UK FCA, for their part, require a "robust, evidence-based

[203] See Articles 23(7) UCITS and 69(6) AIFMD recently amended by amending Directive 2024/927. The principles of acting honestly, fairly, etc. are also found in Article 14(1) (a) UCITS, and Article 12 (1) (a) AIFMD, as well as Article 4 (1) of Regulation 2019/1156 on facilitating cross-border distribution of collective investment undertakings.

[204] Rule 35d-1 under the Investment Company Act of 1940 considers "materially deceptive and misleading" the name of a fund that "suggests an investment focus", including terms indicating that the fund's investment decisions incorporate one or more environmental, social, or governance factors, unless "has adopted a policy to invest, under normal circumstances, at least 80% of the value of its assets in investments in accordance with the investment focus that the fund's name suggests". See https://www.sec.gov/news/press-release/2023-188.

[205] UK FCA SDR and investment labels. See also the Monetary Authority of Singapore (MAS) 66% for ESG funds in MAS Circular No. CFC 02/2022, of 28 July 2022. Available at: https://www.mas.gov.sg/-/media/mas/regulations-and-financial-stability/regulations-guidance-and-licensing/securities-futures-and-fund-management/regulations-guidance-and-licensing/circulars/cfc-02-2022-disclosure-and-reporting-guidelines-for-retail-esg-funds.pdf.

standard that is an absolute measure of environmental and/or social sustainability".[206] One open question is how the ESMA's broader standard may be applied by different NCAs, and thus FMPs.

4.5. Entity-level information… Why? Where? Who?

A first question on entity-level information is: how useful is it? As can be deduced from the previous paragraphs the SFDR functions as a kind of "aggregation" mechanism. **The information disclosed by corporates via the CSRD cannot be processed by the average investor (and, admittedly, nor by most of the sophisticated ones), and even though natural aggregators, like indexes, could do so, there are simply too many of them. The SFDR helps paint a picture for most investors about the market in funds and investments.** What that picture says is less clear, though. **End investors tend to invest in a "product" or fund, not in an asset manager, and it is unclear how entity-level information can be actionable**.[207] Another argument against entity-level information is that, at a corporate level, there is already the CSRD, which is an entity-based reporting legal text, which can result in overlaps and inconsistencies. Indeed, in the Commission's Consultation, FMPs were largely against entity-level disclosures,[208] also indicating that they faced **methodological challenges to "take into account" PAIs at entity level for the "do not significant harm" test at product level**.[209]

However, **there are also other arguments to consider**. If the SFDR objective is not only to cater to investors, but to channel funds towards sustainable investments and make **sustainability factors and risks more salient** across the board, for investors, other stakeholders or regulators (who can, e.g., spot trends, map impacts or risk concentrations), entity-level disclosures can help. Unsurprisingly, while FMPs are opposed, the majority of NGOs favors entity-level disclosures,[210] while NCAs are split on the issue.[211] Disclosures on sustainability risks seem to be more favored,[212] while opinions are more divided on sustainability impacts or remuneration policies.[213]

If entity-level disclosures are kept, reforms could **simplify the requirements**, by focusing only on material issues, or cross-cutting aspects.[214] Another possibility would be to reserve entity-level reporting for the CSRD but require **fund-level reporting** of sustainability risks and PAIs for *all* funds/products managed by each single FMP, **weighted by size**. The key point is that entity-level information is now too high-level, too "narrative" (i.e., not quantitative) and thus useless for any party. Any reform should concentrate on **who may use the information, and for what purpose.**

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206 See UK FCA Annex III. Needless to say, the FCA does not imss the chance to point that the SFDR includes: "no specific link to a robust, evidence-based standard".

207 Commission Summary of responses to Public Consultation and Targeted Consultation, no. 4.3.1., p. 8.

208 Ibidem (52% (94 out of 182) responded 'not at all' or 'not really' and 21% (39 out of 182) responded 'mostly' or 'totally'. The rest responded 'partially' or 'don't know').

209 Ibid no. 4.1. p. 5.

210 Ibid no. 4.3.1., p. 8 (19% (6 out of 32) responded 'not at all' or 'not really' and 59% (19 out of 32) responded 'mostly' or 'totally'. The rest responded 'partially' or 'don't know').

211 Ibidem (29% (4 out of 14) responded 'not at all' or 'not really' and 36% (5 out of 14) responded 'mostly'. The rest responded 'partially' or 'don't know').

212 Ibidem (49% (138 out of 280) of respondents found them 'totally' or ' mostly' useful, while 15% (41 out of 280) responded 'not really' or 'not at all').

213 Ibidem (on impacts 31% (86 out of 281) responded 'totally' or 'mostly' and the same amount responded 'not really' or 'not at all'. The rest responded 'partially' or 'don't know', while on remuneration policies, 39% (108 out of 278) responded 'totally' or 'mostly' and 26% (73 out of 278) responded 'not really' or 'not at all'. The rest responded 'partially' or 'don't know').

214 Ibidem.

4.6. The perspective of retail investors: in summary, the SFDR is not retail investor-friendly

The conclusion from the previous points is that **the SFDR is not a friendly framework for retail investors**. Its disclosures are **complex**, and involve concepts that may be unfamiliar, and **unintuitive for retail investors**. Retail investors are unlikely to understand the implications of PAIs and sustainability risks and may struggle with concepts such as "taxonomy aligned", "sustainable characteristics", or "sustainable objective". They will be unable to differentiate the different types of funds within Article 8 or Article 9 funds and may even struggle with the difference between Article 8 and Article 9 funds. This is confirmed by the surveys conducted by the ESAs,[215] and by the Commission's responses to the consultation.[216]

Finally, the SFDR's **omission of "transition" products** may deprive retail investors from a relevant product characteristic, which they would probably find useful to choose products that, while not making investments that are sustainable, have a clear aim to bring measurable improvements to the sustainability profile of the assets invested in.

This may be in part because catering to investors is one of the SFDR's goals, but not the only one. However, in that case, policymakers should identify **who are the users of SFDR information, and what they use it for**. This could help streamline the requirements and dispense with those that are redundant or useless.

[215] See Joint ESAs Opinion on the SFDR para. 6, p. 3.

[216] Commission Summary of responses to Public Consultation and Targeted Consultation, p. 6.

5. CAN GREEN PROMISES UNDER THE SFDR DELIVER AGAINST THE ODDS?

While sections 3 and 4 have offered a critical approach to the SFDR, this section takes stock of studies of the market in investment product. Despite the SFDR shortcomings, the news are reasonably positive. Sustainability-related features are (moderately) attractive to investors (5.1.), and sustainability disclosures appear to nudge intermediaries to improve their sustainability performance (5.2.) while studies about more "ambitious" funds and fund "reclassification" (from one category to another) throw some notes of caution, but also suggest some aspects that need attention (5.3.)

5.1. Market overview: sustainability-ish is attractive (up to a point) and the industry dreads strict criteria and uncertainty

Market research helps to provide a general picture of the market in SFDR funds. Morningstar, which regularly reports on SFDR funds, reports Article 8 funds as the most popular segment, with 55% of the market (measured by assets), Article 6 funds come next, with 41,1%, and Article 9 funds a distant third, with 3,4% (Article 8 and 9 funds are also relatively larger, by asset size[217]). This suggests that it is more attractive to market a fund if it has sustainable "characteristics" than if it does not.

Surveys conducted by authorities, like the **UK FCA** bear this out.[218] They found that "**sustainability**" is **one of many factors that consumers consider** when evaluating investments, but that they **feel uncertain** about its meaning, because there is no single agreed definition, there is a lot of information to process (at a minimum, some consumers apply a "do no harm" policy, e.g., excluding tobacco companies). Conversely, "**labels**" tend to give consumers **confidence** about products' sustainability claims, as they are more relatable, and facilitate information-gathering.[219]

The problem is that the SFDR is used as a labelling regime without being one. While Article 8 funds are marketed as "light green", the SFDR does not set minimum criteria to be complied with by any of the products. Over one third (35%) of Article 8 funds (by assets) have a 0% target of sustainable investments, and nearly 15% have a target in the 0-10% range, and nearly 20% a target in the range 10-20%.[220]

Thus, FMPs appear to appreciate the "greenness" of a label as a marketing tool but they are more reluctant to market Article 9 funds. They are not ready to incur the cost and risk of non-compliance, which Article 9 entails. This suggests that, although there may be "**greenwashing**", "**green bleaching**" may be more widespread, and should be seriously studied. Should "Article 8" and "Article 9" (or similar) be transformed into categories or labels, however, the question is whether declassifying these little-ambition Article 8 funds would serve investors' interests better, or would channel more funds to sustainable (or transition) investments. If "little but not null" ambition represents a large part of investor preferences, one should think about new categories that could capture those preferences.

[217] See, e.g., Morningstar Manager Research April 30, 2024, p. 8, exhibit 6a. The numbers change if measured by number of funds, where Article 8 funds represent 44,3%, Article 6 funds 51,6%, and Article 9 funds a 4,1%.

[218] Sustainability Disclosure Requirements (SDR) and investment labels regime (Qualitative Research) Executive summary | 24.11.2023. Available at: https://www.fca.org.uk/publication/external-research/sdr-investment-labels-regime-qualitative-research.pdf.

[219] Ibid. See also Joint ESAs Opinion on the SFDR, para. 14, p. 10 (favoring product classification to improve clarity).

[220] Morningstar Manager Research April 30, 2024 p. 17, exhibit 16.

A final consideration is that revisions of targets in both Article 8 and Article 9 funds tend to be upwards (increasing sustainable investments[221]), and that the *reported* levels of sustainable investments are higher than the planned levels (sometimes significantly so[222]). This reinforces the impression of "green bleaching", or, more benignly put, **a tendency to under-promise, and over-deliver, at least in terms of sustainable investments. This is in line with financial intermediaries' risk aversion, and it also seems to be confirmed by the outflows of Article 9 funds**. Thus, any measure tending towards a product classification system should take this into account, to avoid creating categories that are so selective that no one qualifies.

5.2. The performance of SFDR funds: do disclosures improve sustainability?

Although the measuring of the performance of socially-responsible funds elicited some interest in the early 2000s,[223] this was relatively rare, and it was not until later that changes in investor preferences and market practices led to **a burgeoning literature on the subject**. **A specific strand within this literature tries to study the impact of sustainability disclosures in firms' sustainability performance,** with a larger body of literature concentrating on non-financial firms, finding that, e.g., upon the introduction of mandates to disclose Scope 1 and 2, regulated firms tend to reduce carbon emissions relative to other firms.[224]

For investment funds and financial firms, some studies concentrated on voluntary commitments, finding that they have little impact on the investment practices of fund managers: **self-defined ESG funds do not tend to invest in companies with stronger sustainability scores**,[225] while **fund managers adhering to** the UN Principles of Responsible Investment (**PRI**) experience important **inflows** of money, but **do not improve fund-level ESG scores** or fund returns, [226] i.e., PRI were a good credential for marketing purposes, but not a lever for meaningful change.

Studies on the SFDR offer some words of caution, but also some promising results. Some early studies pointed that at financial actors' lack of a comprehensive framework to track and measure their social and environmental contributions,[227] or suggested that, from the perspective of the incentives of investment managers, Article 9 funds and Article 6 funds had incentives to behave similarly from both

[221] Ibid pp. 18-19, exhibits 17 and 18.

[222] Ibid pp. 22-23, exhibit 22. Almost two thirds (65%) of the funds reported holding at least 30% of sustainable investments, which is much higher than the 30% that originally planned to reach that minimum level.

[223] M.J. Munoz Torres, M.A. Fernandez Izquierdo, M.R. Balaguer Franch "The social responsibility performance of ethical and solidarity funds: an approach to the case of Spain" Bus Ethics Eur Rev 13(2/3) (2004) pp. 200–218.

[224] For the UK estimates of the reduction vary. B. Downar, J. Ernstberger, S. Reichelstein, S. Schwenen andA. Zaklan The impact of carbon disclosure mandates on emissions and financial operating performance Review of Accounting Studies, 26, (2021) pp. 1137-1175 tend to find a reduction of 8%, while V. Jouvenot, P. Krueger Mandatory Corporate Carbon Disclosure: Evidence from a Natural Experiment. Working Paper, (2021). Available at: https://ssrn.com/abstract=3434490) found a 16% reduction. For the US, S. Tomar; Greenhouse Gas Disclosure and Emissions Benchmarking. Journal of Accounting Research, 61 (2) (2023), pp. 451-492 and L. Yang, N. Muller, P.J. Liang, The Real Effects of Mandatory CSR Disclosure on Emissions: Evidence from the Greenhouse Gas Reporting Program. NBER Working Paper 28984, (2021). Available at: http://www.nber.org/papers/w28984) find reductions of 8% and 7%.

[225] R. Raghunandan, S. Rajgopal, "Do ESG funds make stakeholder-friendly investments?" Review of Accounting Studies, 27, (2022), pp. 822–863; R. Gibson Brandon, S. Glossner, P. Krueger, P. Matos, T. Steffen "Do responsible investors invest responsibly?" Review of Finance, 26 (6) (2022), 1389-1432.

[226] S. Kim, A. Yoon Analyzing Active Fund Managers' Commitment to ESG: Evidence from the United Nations Principles for Responsible Investment. Management Science, 69 (2) (2022), pp. 741– 758.

[227] Irene Bengo, Leonardo Boni, Alessandro Sancino "EU financial regulations and social impact measurement practices: A comprehensive framework on finance for sustainable development" Corporate Social Responsibility and Environmental Management (2021) pp. 809-819.

the financial and sustainability perspectives (i.e., similar incentives were present), suggesting a certain "category fuzziness".[228]

While such studies primarily focus on financial actors' *ex ante* preparedness to apply the new framework, other studies yield more **positive findings about the SFDR's *effects***. Some, like Birindelli et al., show that investor attention towards the SFDR tends to have an influence in market prices, mostly during bearish and normal market conditions (though the study does not focus on whether the price effect is positive or negative[229]). Becker, Martin and Walter[230] analysed the SFDR effect on the demand side and the supply side. On the demand side, **Article 8 and 9 funds did see positive net inflows** compared with less sustainable EU funds, a finding in line with the literature, which has found that funds associated with better ESG alignment tend to attract higher inflows[231]. This demand-side effect must be considered with caution, though, as other studies might suggest that investments flow more in response to industry ratings than to SFDR classification[232]. Furthermore, demand-side effects suggest that certain regulatory labels have the power to attract investment flows, but not whether this results in the kind of meaningful change sought by the SFDR.

Crucially, Becker et al. also find that, on the supply side, increasing transparency of sustainability enforced by the new regulation incentivised mutual funds to increase their ESG efforts: **EU funds**, under the SFDR, **increased their ESG scores** more than funds in the non-EU control group[233].

ESG scores are not the same as ESG "outputs". However, a more recent study by Dai, Ormazaval, Peñalva and Raney (hereafter: Dai et al.) confirms that the **SFDR had a positive impact on carbon intensity, i.e., one specific sustainability factor**:[234] Funds under Articles 8 or 9 of SFDR exhibit lower levels of portfolio carbon emissions following the implementation of the SFDR. The improvement of SFDR funds was measured against a control group of funds not subject to the SFDR, but managed by firms that are signatories of the UN PRI 13,7% for Scope 1 emissions, and a 6,6% for total Scope 1, 2 and 3 emissions.[235] The authors discard alternative explanations, such as changes induced at the level of corporates by the Non-Financial Reporting Directive (NFRD) or CSRD (the study takes measures before and after the SFDR entered into force, when the NFRD was in place, and the CSRD was not yet in force[236].

[228] Chiara Cremasco, Leonardo Boni "Is the European Union (EU) Sustainable Finance Disclosure Regulation (SFDR) effective in shaping sustainability objectives? An analysis of investment funds' behaviour" Journal of Sustainable Finance and Investment (2022).

[229] Giuliana Birindelli, Helen Chiappini, Raja Nabeel-Ud-Din Jalal "SFDR, investor attention, and European financial markets" Finance Research Letters, no. 56 (2023), 104135.

[230] Martin G. Becker, Fabio Martin, Andreas Walter "The power of ESG transparency: The effect of the new SFDR sustainability labels on mutual funds and individual investors" *Finance Research Letters* no. 47(B) (2022) 102708.

[231] See, e.g., Sadok El Ghoul, Aymen El Karoui "What's in a (Green) Name? The Consequences of Greening Fund Names on Fund Flows, Turnover, and Performance" *Finance Research Letters* 39 (2021) 101620.

[232] F. Ferriani The importance of labels for sustainable investments: SFDR versus Morningstar globes (2022). SSRN Electron. J. Available at: https://doi.org/10.2139/ssrn.4166932.

[233] Becker et al. (2022).

[234] Jiyuan Dai, Gaizka Ormazabal, Fernando Penalva, Robert A. Raney "Imposing Sustainability Disclosure on Investors: Does it Lead to Portfolio Decarbonization?" ECGI Finance Working Paper N° 945/2023 (hereafter: Dai et al. 2023).

[235] Dai et al. 2023. They find that changes were driven only partly by investment returns, i.e., firms not only invested in companies with better returns; they also divested in firms with higher emissions and invested in firms with lower emissions. The authors use different control groups to test their results, including EU funds that do not claim to use sustainability criteria (Article 6 SFDR "grey" funds), US-domiciled non-SFDR PRI signatories, ESG funds according to Morningstar, propensity score matched non-SFDR PRI signatory funds (matched on fund size and emissions), and funds from within the same fund family (i.e., funds managed by the same asset manager) that were not impacted by the SFDR.

[236] The study controlled the results for non-EU investment firms (which could be less 'tilted' towards EU corporates) marketing products in the EU, and also compares the SFDR funds with US-domiciled funds. Dai et al. 2023.

Although it is too soon to tell whether this trend is well-established, and whether it works beyond portfolio carbon intensity, these are promising findings. The authors also found that the reduction in portfolio carbon intensity was significantly **lower in SFDR funds previously subject to disclosure requirements under national laws**, such as the French Energy Law of 2015.[237] It is worth noting that the French Law required institutional investors to report on: (i) the integration of ESG criteria in investment policy and risk management; (ii) the integration of climate change-related risks; and (iii) the alignment with voluntary decarbonisation targets,[238] at an entity level *plus* at a fund level, for funds above EUR 500 million (the largest funds[239]) *regardless* of the type of fund. Thus, the French Law combined entity-based and fund-based disclosures, and "nudged" more than "labelled", though it left relative flexibility to differentiate by activity, asset class, investment portfolio, issuer, sector or any other relevant distinction.[240]

These findings suggest that, **even if rules are complex** to implement, and market actors are not always ready to implement them properly, such **actors adapt their behavior in response to the rules when the general message, or signal is sufficiently clear**.

5.3. Studies about "ambitious" funds (Article 9 and "impact"), and fund reclassification

While the previous point takes stock of studies that have tried to illustrate the impact of the SFDR on fund performance, this one concentrates on two, more specific types of studies: first, those that focus on concrete details within the more ambitious segment of the market, i.e., "Article 9 funds", or funds with an "impact claim"; second, those that focus on the "reshuffling" of funds, i.e., on the reclassification of funds between different categories (Article 9, 8 and 6) and the inflows and outflows of money into those categories.

On the "**ambitious**" funds, Chesney and Lambillon examine the companies included in "Article 9" or "dark green" funds. The authors raise questions on fund managers' definition of "sustainable investments"[241]. They find that the **inclusion of stocks in Article 9 funds** is **driven by companies' efforts to improve their corporate sustainability profile**, such as the incorporation of science-based net zero targets or human rights policies, as well as their obtention of higher ESG ratings.[242] Other considerations, such as the violation of UN Global Compact or OECD guidelines for multinational enterprises have no significant effect in the inclusion/exclusion of companies in the funds. The study also differentiates between "**regional**" and "global" **Article 9 funds**, finding that the former have a **more limited** consideration of **double materiality**, their **share of "sustainable investments" lower**, and are **likelier to be re-classified** (as Article 8 funds)[243].

[237] Article 173-VI Loi no. 2015-992 of 17 August 2015 relative à la transition énergétique pour la croissance verte (relative to the energy transition for green growth), which modified Article L533-22-1 of the French Financial and Monetary Code. The Decree Implementing the legal reform was the Decree no. 2015-1850 of 29 December 2015, applying Article L. 533-22-1 of the French Financial and Monetary Code.

[238] Article L533-22-1, and Article D533-16-1 of the French Financial and Monetary Code, as amended.

[239] Article D533-16-1 of the French Financial and Monetary Code, as amended sect. II, no. 2°.

[240] Ibid.

[241] Marc Chesney, Adrien-Paul Lambillon"How green is 'dark green'? An analysis of SFDR Article 9 funds". Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4366889.

[242] Ibid.

[243] Ibid.

Scheitza, Busch and Metzler (2022) focus on funds with some kind of "impact" claim, to see whether it is justified, in light of established classification schemes for factual impact investments[244]. They found that **only one-third of the impact funds analysed met the impact requirements** (based on the classification scheme by Busch et al.[245]). The share that was equally low for funds classified under Article 9 SFDR (the share of funds meeting impact-generating requirements was higher for private equity and private debt than for public equity and bonds). This suggests that former ESG funds may have been rebranded as "impact funds" to attract capital, i.e., "**impact washing**".[246]

Scheitza and Busch (2024), for their part, conduct a granular study of funds classified as "Article 9" funds under the SFDR.[247] Using the G7's new typology of "sustainable investments", they show that **Article 9 funds have a varying degree of ambition**: while 60 % follow an impact-oriented strategy, a 40 % pursue a general Environment, Social, and Governance (ESG) strategy instead.[248] The authors do not find significant differences in ESG scores between ESG-related and impact-related funds, but impact-related funds have higher SDG impact scores and higher management fees. Focusing on the "downgraded" funds, i.e., funds that changed their SFDR-status, these tended to be less focused on impact.[249]

Other studies have focused on the "**declassification**" of funds. Badenkoop, Hackmann, Mücke and Pelizzon observed **a substantial number of funds being "declassified" as Article 9 and reclassified as Article 8 funds**. The result was a **sharpening of the profile of SFDR classes**, with an **increased share of sustainable investments in Article 9 funds**. As a result, in the group of Article 9 funds the share of environmental investments increased, but the share of social investments decreased. The measured share of taxonomy-aligned investments was very low, but increased slightly for Article 9 funds, and few funds reported the proportions of sustainable investments.[250]

This study suggests that the additions and clarifications of the SFDR have sharpened the profile of the SFDR classifications and increased its accuracy. The downside, however, is that, for categories where there may be greater uncertainty, and difficulties of measurement (as for funds with a "social" objective) FMPs may tend to de-classify their funds if there is a risk that they may be found in breach. Thus, although improved precision in funds' profile is a positive development, it is also an instrumental one: the true measure of success is whether this helps to better cater to investors' preferences, and/or shift funds in a way that effects real change.

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[244] Lisa Scheitza, Timo Busch, Johannes Metzler "The impact of impact funds: A global analysis of funds with impact-claim" Capco Institute Journal for Financial Transformation no. 56 (November 2022).

[245] Busch et al. (2021). See supra 4.4.1.

[246] Scheitza, Busch, Metzler (2022).

[247] Lisa Scheitza, Timo Busch "SFDR Article 9: Is it all about "impact"? Finance Research Letters 62 (2024) 105179.

[248] Ibid.

[249] Ibid.

[250] Ibid. As of March 2023, only about 1,000 funds reported their sustainability proportions. This should change as all funds within the SFDR are required to report these proportions in their annual reports after 1 January 2023.

6. HOW TO FURTHER ACCOMMODATE THE SFDR REGULATORY FRAMEWORK TO ITS INTENDED GOALS

6.1. Reforming the SFDR: asking the right questions, considering the SFDR users, and usability

Any reform of the SFDR should start by asking the right questions. There seems to be agreement about the SFDR shortcomings. How to address them depends on what the SFDR should achieve, i.e., "catering" or "transformation" (6.1.1.), who are the users of the SFDR information (6.1.2.), and whether this information is usable (6.1.3.)

6.1.1. The SFDR: a "catering" or a "transformational" instrument?

An analysis of the regulatory framework and the literature shows that, (i) first, the SFDR, and the information infrastructure that feeds into it, is complex, and complying with it is costly, and, (ii) second, investors, especially retail investors, do not have a use for most of the information generated by the SFDR. If these findings are considered cumulatively, one could conclude that the SFDR should be transformed into a more targeted instrument, for a subset of products. However, the conclusion may be very different, if these findings are considered separately.

First, **the information infrastructure** generated by the SFDR, in combination with the CSRD, Benchmarks regulation etc., **is complex, and costly** to comply with, but a large part of this cost is an **initial investment** in capacity building. There is a learning curve, and such initial investment may be justified if the basic building blocks are stable. Also, **some problems and frictions are inevitable** when a massive infrastructure is built from scratch without any precedents.

Second, investors, especially retail investors, have little use for most of the information churned out by the SFDR. They may find useful the product information, and only up to a certain extent (most retail investors will struggle to distinguish the basis for distinguishing between "light" and "dark" green, let alone "ESG" and "impact" funds).

If the SFDR merely tried to cater to established and stable sustainability preferences, it should be stripped down to its basic, product-based rules, and these should be substantially simplified. However, if preferences are fluid, making sustainability factors more salient can help shift preferences and reorient investment flows.

Thus, a lot depends on whether the SFDR is a "catering" or a "transformational" text, a loaded question in policy terms, with clear political implications.

6.1.2. Who uses the SFDR, and for what?

The previous point has implications for who are the actual addressees of the information generated by the SFDR.

- **Investors**, especially retail ones, will find product information to be more useful (thus, section 6.3. is primarily relevant for them).
- **Other stakeholders**, however, may find uses for other information produced under the SFDR, such as PAIs, including at entity level. Workers, NGOs and other societal actors may screen this information to raise questions and engage in dialogue with FMPs and FAs, if, e.g., a financial intermediary with a large presence in the market of sustainability-related products does simultaneously have a worrying record of investing in companies with adverse impact records.

This may be because it has very different approaches to different market segments, because it lacks a common culture towards sustainability, or for other reasons.

- Finally, information about risks (also about PAIs) is useful for **supervisory authorities**, which may use it to map risks, and spot any inconsistencies between the FMPs claims at a product and entity level.

This also means that **different types of information may feed into different processes and dynamics**.[251] Retail investors may primarily be interested in actionable, easy-to-operate classifications, which enable their decisions to invest, or divest (**exit dynamics**[252]). **Clarity and precision**, as well as top-down (i.e., from corporates, to gatekeepers, to aggregators, to fund managers, to investors) streamlining of the information pipeline is a priority.

Some sophisticated investors, such as pension funds investing in specific types of funds, or other stakeholders (NGOs and other social actors) may be interested in more complex and granular information, to engage with financial intermediaries, which may, in turn, **engage** with the corporates they invest in (**voice dynamics**[253]).

Finally, supervisory authorities are interested on both levels of the information: the simpler information may be used to penalise unsubstantiated (greenwashing) claims (**penalty**[254]), while the more complex information may be used to **assess and map risks** and anticipate potential problems.

6.1.3. The SFDR: reforming for usability

The SFDR is a complex text, which generates a lot of information that is costly to produce, yet insufficiently or inadequately used. Part of it was due to lack of experience. Now **there is experience, and a better sense of how different actors may use the information**, and **reformers should ensure that the new text improves usability for all actors**. This, of course, encompasses **investors**, and authorities should have more frequent recourse to **consumer testing**[255] (infra 6.3.) However, it goes beyond that, since authorities should also **improve usability by all actors.** This may require the authorities to **go beyond a purely "prescriptive" role** (legislation and enforcement) and **into a more "constructive" role**, facilitating the accessibility of tools to build the methodologies and generate the disclosures (6.2.)

[251] David Ramos-Muñoz; Elia Cerrato; Marco Lamandini "The EU's "green" finance. Can "exit", "voice" and "coercion" be enlisted to aid sustainability goals?" European Banking Institute Working Paper Series 2021 - no. 90.

[252] Ibid.

[253] Ibid.

[254] Ibid. See supra 4.2.2. (greenwashing).

[255] Joint ESAs Opinion on the SFDR, no. 2.1., para. 11, p. 6.

6.2. The SFDR and the information infrastructure: norm consistency, and technology building

The SFDR's different goals, and the need to coordinate with other legal texts poses normative challenges (**6.2.1.**), but also, and primarily, technological challenges (**6.2.2.**).

6.2.1. The SFDR normative challenges: the interplay with information supply and demand

Corporates' supply the information for SFDR parties. Corporates' disclosure "outputs" under the CSRD are the "input" for FMPs and FAs under the SFDR. The Commission has made some efforts to facilitate alignment *ex ante*, between the Level 2 texts for CSRD and SFDR, especially on "adverse impact". However, these should be accompanied by an *ex post* assessment of where the information gaps and bottlenecks actually lie.

In terms of measures that can be already adopted, **the "materiality" dimension should be consistent across legal texts, and FMPs should be able to rely on corporates' assessments, unless there are gaps and doubts, in which case they should ask and engage.** In terms of structuring the information, the CSRD could adopt a more "modular" approach, whereby the information that is SFDR-relevant is clearly identifiable and can be more easily exported into SFDR reporting. This should make it easier for FMPs to process that information into their "impact" disclosures.

FMPs and FAs heavily depend on "infomediaries", such as benchmarks administrators, ratings providers and other data providers.[256] Benchmarks are regulated, and expressly acknowledged in the SFDR. ESG rating providers are regulated since recently, and not acknowledged in the SFDR.[257] Other providers are neither regulated nor acknowledged. Financial institutions should be able to rely on benchmarks and ratings, and third-party providers, but not blindly. **Legislators and authorities may learn from the experience of banks' overreliance on external credit ratings to assign risk weights to avoid making the same mistakes.**[258]

Some additional challenges remain, though. First, for banks, credit risk (the relevant variable supplied by rating agencies) can be measured objectively by combining "probability of default" (PD) and "loss-given default" (LGD). **Both ESG ratings and benchmarks can mean different things and be used for different purposes**. If an FMP product is *defined* as passively tracking a specific benchmark, or as investing in companies that register improvements in ESG ratings, it must accommodate its disclosures to its investment strategy,[259] but not more. Requiring financial intermediaries to go beyond that means abandoning the SFDR's current "neutrality" in product design,[260] in which case **the more prescriptive parameters should be clear**. Second, there must be an incentive for financial intermediaries to "sell"

[256] Ramos-Muñoz, Smolenska (2023).

[257] The Commission proposed the Regulation in June 2023. See Commission Proposal for a Regulation of the European Parliament and of the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities. Strasbourg, 13.6.2023 COM(2023) 314 final. The parliament adopted the proposal on 24 April 2024, available at: https://www.europarl.europa.eu/doceo/document/TA-9-2024-0347_EN.pdf. For an analysis of infomediaries, and the Regulation, see Ramos-Muñoz, Smolenska (2023); Michele Siri; Matteo Gargantini "Information Intermediaries and Sustainability: ESG ratings and benchmarks in the European Union" ECMI Working Papers (2022).

[258] See, e.g., EBA, EIOPA and ESMA Final Report on Mechanistic references to credit ratings in the ESAs' guidelines and recommendations (JC 2014 004), 6 February 2014, ESAs Final Report Good Supervisory Practices for Reducing Mechanistic Reliance on Credit Ratings, JC 2016 71, 20 December 2016, or, more recently, EBA Report on External Reliance on External Credit Ratings (Directive 2013/36/EU). EBA/REP/2021/10.

[259] SFDR Q&A, Section V. Financial product disclosures, Q1

[260] Supra 4.1.

their expertise or ambition. Presently, it is preferable to follow passive-tracking strategies. Financial intermediaries will assume the cost of additional explanations and tracking only if they can benefit from this, e.g., by relying on "**high quality**" labels.

Any reform of SFDR from the perspective of investor demand must be aligned with MiFID. The SFDR is used as a labelling scheme, but it does not work properly like one, because it was not designed for that purpose. The product-design neutrality, the complexity of disclosures, and the role of self-reporting mean that SFDR disclosures are very hard to explain in terms of investors' "sustainability preferences", and do not allow comparability between products, or matching products and preferences.[261] **The new rules should be more prescriptive about categories**, (e.g., "sustainable", "impact", "transition", "sustainability riskminimisation" or "negative screening" etc.), **concepts** (what counts as "sustainable", or "impact"), or **levels** (what are the minimum thresholds that a product must meet to qualify). The definition of sustainability preferences should be adjusted accordingly, to make the suitability assessment more predictable. Since prescriptiveness improves clarity but limits choice, the authorities should balance this by testing such concepts, categories and levels to ensure that they can capture the preferences of a sufficiently large part of the market.

These conclusions have implications in terms of the capacity-building of financial intermediaries (next point, 6.2.2.) and product design (point 6.3.)

6.2.2. The SFDR technological challenges: a Sustainability Information Infrastructure (SII)

Even if the legal rules should be more coordinated and streamlined, **the SFDR presents mostly technological/methodological challenges.**

The data must flow seamlessly from corporates into benchmarks and ratings, and from these into FMPs/FAs and funds. One shortcoming of the current process is the **insufficient emphasis in capacity-building by the industry through a collaborative exercise** with authorities. To give an example, the ECB's ambitious climate and environmental strategy involves not only a conventional exercise of supervisory powers, but also a collaborative exercise with the industry to help banks' capacity-building, modelling and best practices.[262]

The ESAs have identified some of the SFDR technological challenges. They have included in their proposed revisions of the Level 2 CDR 2022/1288 a requirement that the reported information be machine-readable.[263] More generally, **EU authorities are well-aware of the data implications of sustainability information, as shown in the recent Regulation on the European Single Data Point (ESAP[264])**. The ESMA, for its part, highlights the importance of tools such as Natural Language Processing (NLPs) and even machine-learning (ML) processes in the *detection* of greenwashing.[265]

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[261] Commission Summary of responses to Public Consultation and Targeted Consultation, p. 7.

[262] See, e.g., Section 6.2. (Guidance on best practices) ECB Climate risk stress test. July 2022. Available at: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.climate_stress_test_report.20220708~2e3cc0999f.en.pdf and also ECB report on good practices for climate stress testing. December 2022. Available at: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.202212_ECBreport_on_good_practices_for_CST~539227e0c1.en.pdf.

[263] ESAs Final Report on draft Regulatory Technical Standards on the review of PAI and financial product disclosures in the SFDR Delegated Regulation. JC 2023 55. 4 December 2023, p. 3.

[264] Regulation (EU) 2023/2859 of the European Parliament and of the Council of 13 December 2023 establishing a European single access point providing centralised access to publicly available information of relevance to financial services, capital markets and sustainability (emphasis added). Recital (12) and Article 5 (1) (c) (i) emphasize the need of data in machine-readable format.

[265] ESMA Greenwashing Report, 2024, p. 24, paras. 64-66. It also advises the Commission to strengthen the TSI to support supervisory convergence across the EU and to foster standardisation and machine-readability of sustainability disclosures. See ibid Annex I, nos. 2.5.3. and 4.4.3.

Outside the EU, technological tools to detect and analyse ESG-related claims are being explored or tested in Australia, Singapore, Hong Kong or the UK.[266]

However, the **authorities fail to see a role for them in aiding the development of methodologies, technology tools and capacity building by the industry**. Such constructive role would be welcome. The ESAs greenwashing reports, and their complementary views on the matter, provide guidance on this. **ESMA** has developed the more comprehensive (and prescriptive) framework, and **rightly spotted the implications for technology and information-processing** but sees the issue of technology tools in terms of supervisory (i.e., not industry) capabilities.[267] The **EIOPA** does not mention NLPs, or ML, but its **more "educational" approach**, which seeks to develop principles, and use them to help the industry distinguish "good" and "bad" practices[268] **is also necessary**. Should the ESAs engage in a constructive process, to aid in "building" the methodologies and tools, this would greatly help to generate an information infrastructure, where greenwashing is more easily identifiable. **If the authorities limit themselves to a legislative and policymaking role, this will only increase the divide between large asset managers, with proprietary technologies, and those without them, and strengthen the role of third-party data services providers**, which will hold a key position in any change in the framework, by providing the methodologies (and thus the concepts and frames) used by many FMPs and FAs (supra 4.3.2.).

In summary, ideally **law and technology should march in lockstep**, and the capacity-building in the ESAs and NCAs should be mirrored by the industry. Authorities should work with the industry to enable financial intermediaries to develop their own methodologies, which means facilitating the technologies to process the information and make it interoperable. In a sense, focusing on "greenwashing" first puts the cart before the horse: **it is important to understand first what "good" practice looks like, and how to build it, to be able to spot the "bad".**

6.3. What to do about labelling and simplification? Product names, minimum standards, single indicator and consumer testing

Product names and categories are useful. Clients consider products carrying certain labels, or placed within certain categories, more attractive and are readier to invest in them. This can be seen in market trends, e.g., the widespread presence of Article 8 funds,[269] or specific studies, e.g., those conducted by the UK's FCA.[270] Conversely, **the current SFDR system, where disclosure requirements are used as labels, results in great confusion**.[271] Responses to the Commission's Consultation agree that a category system would cater to investor preferences, combat greenwashing, limit fragmentation, and facilitate the understanding of sustainability-related characteristics for retail investors, but also for professional investors.[272]

However, it is important to bear in mind that, when marketing "sustainability-oriented" products **financial institutions make a cost-benefit analysis**. Article 8 funds are widespread (above 50% of SFDR funds by assets), while Article 9 funds, which carry a greater regulatory cost, and greater risk of

[266] IOSCO Greenwashing Report, 2023, p. 39.

[267] ESMA Greenwashing Report, 2024.

[268] EIOPA Greenwashing Report, 2024.

[269] Supra 5.1.

[270] Supra 5.1.

[271] Joint ESAs Opinion on the SFDR, para. 15, p. 10, cross-referring to the individual ESAs Reports on Greenwashing. See supra 4.2.2. for further detail.

[272] Commission Summary of responses to Public Consultation and Targeted Consultation, p. 11, no. 4.4.1.

non-compliance, are a minority segment (less than 4% of assets). Although **greenwashing is a concern**, preliminary evidence suggests that "**green bleaching**" may be more widespread,[273] and, while greenwashing is a malpractice that undermines confidence in the market, green bleaching can encompass legitimate regulatory arbitrage, whereby FMPs do not market a specific product as too ambitious because the benefit in terms of clients' interest is not worth the cost, in terms of compliance, and regulatory uncertainty.

Thus, when designing product labels legislators need to **balance** the "**precision**" of the categories, with their "**reach**", i.e., how much of the market can be (realistically) covered. This depends on the legislators' priorities.[274] **If the SFDR is a "catering" text that assumes fixed preferences, legislators should prioritise precision; if it is a "transformational" text, the SFDR should be broad enough to encompass a large part of the market, and create incentives for FMPs to improve their sustainability**.

Our views align with the responses to the Commission Consultation, which consider that new categories should be based on different concepts than current Articles 8 and 9 SFDR.[275] Our views also align with the responses in considering that the categories of **"impact" products (Category A[276]) and "transition" products (Category D[277]) should be included**. Both have a transformational goal, and, although, "impact" is more precise, and may be better understood than "transition" (as suggested by the UK FCA's qualitative analysis[278]) transition-based products have potentially the larger "reach", and a transformational SFDR should make them a priority.

Our views are **more reluctant towards an "exclusionary" approach** (Category C), as it would exclude investments susceptible of improvement.[279] This was also the category that attracted less support in the responses to the consultation.[280] However, studies, like that conducted by the UK FCA, suggest that investors, at a minimum, apply a "do no harm" policy when searching for investment.[281] Thus, while not serving a "transformational" goal, **it may serve a "catering" goal**.

We are also doubtful about the category of **products** "**aiming to meet credible sustainability standards or adhering to a specific "sustainability related theme**" (Category B[282]) as it seems **vague**. However, its virtue may be in its potential **breadth and flexibility** to accommodate different

273 Supra 4.2.2. and 5.1.

274 Supra 6.1.1.

275 Commission Summary of responses to Public Consultation and Targeted Consultation, p. 12, no. 4.4.2.

276 "Products investing in assets that specifically strive to offer targeted, measurable solutions to sustainability related problems that affect people and/or the planet, e.g. investments in firms generating and distributing renewable energy, or in companies building social housing or regenerating urban areas". Commission Targeted Consultation, Q 4.1.4. Category A.

277 "Products with a transition focus aiming to bring measurable improvements to the sustainability profile of the assets they invest in, e.g. investments in economic activities becoming taxonomy-aligned or in transitional economic activities that are taxonomy aligned, investments in companies, economic activities or portfolios with credible targets and/or plans to decarbonise, improve workers' rights, reduce environmental impacts". Commission Targeted Consultation, Q 4.1.4. Category D.

278 The category "Sustainable Improvers", which is the closest to "transition" was considered the least clear. (SDR) and investment labels regime (Qualitative Research) p. 5. "Most consumers interpret the name 'improve' as working to improve which assets the fund invests in, rather than the assets themselves working to improve their sustainable goals".

279 "Products that exclude activities and/or investees involved in activities with negative effects on people and/or the planet". Commission Targeted Consultation, Q 4.1.4. Category C.

280 Around 33% disagreed to a large or a limited extent with its usefulness (34 and 57 votes), against around 38% who agreed to a large, or very large extent (48 and 57), while 20% agreed "to some extent" (55), and 9% did not know. Commission Summary of responses to Public Consultation and Targeted Consultation, p. 12, no. 4.4.3.

281 (SDR) and investment labels regime (Qualitative Research) p. 2.

282 Products aiming to meet credible sustainability standards or adhering to a specific sustainability-related theme, e.g. investments in companies with evidence of solid waste and water management, or strong representation of women in decision-making. Commission Targeted Consultation, Q 4.1.4. Category B. Next to the "exclusionary" category C, category B elicited the least enthusiasm.

preferences, while improving sustainability measures across the board, like Article 8 seems to do now.[283] In any event, rather than a single category, this could give rise to **multiple types of products**. Indeed, the ESAs suggest that a "sustainable products" category may be split into two sub-categories of environmentally sustainable products, based on the Taxonomy, and socially sustainable products.[284]A further sub-division by theme may take this idea further.

Another clear conclusion is that the products "**names**", or categories, need to be considered **together with the "metrics"**, i.e., the mechanisms to ensure measurability and accountability. In the Commission's consultation opinions were split as to whether the categories should be accompanied by an already-defined set of KPIs/indicators (and potentially a certain level of ambition or quantitative thresholds), or if indicators should be chosen by FMPs in a flexible manner to allow for a wide range of investment strategies and avoid narrowing the scope of investment options.[285] **In principle, our views favour the certainty of setting minimum thresholds.** However, this should be left to the ESAs, especially the ESMA and the EIOPA, which should be empowered to prescribe admissible KPIs, and minimum thresholds (with a clearer mandate than the ESMA currently has for its "funds' name" guidelines[286]) but to also cooperate with the industry in defining the metrics and categories. The ESAs have already indicated their **preference for establishing minimum thresholds**, e.g., in the form of percentages of Taxonomy-aligned investments, which could increase with time, as taxonomy-aligned activities also grow, while non-aligned investments should at least respect the DNSH and good governance requirements.[287]

This makes it necessary to revisit the concept of "sustainable investment". Currently the gap between the SFDR and the Taxonomy Regulation is closed via interpretation. This should be done via legislation, which should also better align the key concepts (e.g., avoiding having two "do no significant harm" (DNSH), as discussed supra 4.3.1.) If, as concluded above, more clarity means more prescriptiveness, the **"sustainable investments" key parameters should be mandatory**, and rely on **Taxonomy-aligned activities**, or in objective (and, where possible, science-based) **metrics**,[288] set by the Commission, or by the ESAs.

Our **views are more cautious towards prescribing a "sustainability indicator"** that illustrates to investors the sustainability features of a product in a scale.[289] In principle, boiling down complex information into a single metric that is "easily digestible" sounds good, but implementation looks challenging. First, the examples offered by the ESAs (the PRIIPs Key Information Document (KID) synthetic risk indicator, or the Energy Performance Certificate) are not suitable, because are they are homogeneous enough to be reduced to a single scale, something that does not happen with sustainability, which operates at least along "environmental" and "social" dimensions. Second, a single indicator could be too deterministic and defeat the purpose of the new categories, which try to reflect not only degrees of sustainability ambition, but also ways to understand such ambition (e.g., some investors would not accept that a fund making sustainable investments is "better" than a fund seeking to create impact by making firms transition).[290] Finally, there is the question of who would supply the indicators, since this could be yet another way to increase reliance on third-party service providers. This

[283] Supra 5.1. and 5.2.

[284] Joint ESAs Opinion on the SFDR para. 21 (a), p. 11.

[285] Commission Summary of responses to Public Consultation and Targeted Consultation, p. 13.

[286] Supra 4.4.2.

[287] Joint ESAs Opinion on the SFDR para. 21 (a), p. 11.

[288] Joint ESAs Opinion on the SFDR paras 41-45, p. 18.

[289] Joint ESAs Opinion on the SFDR para. 26, p. 13.

[290] The ESAs are very honest and open about these problems. See Joint ESAs Opinion on the SFDR paras. 31-34, p. 15.

cautions against overly prescriptive measures. However, the authorities could experiment with tools that allow investors to obtain a single indicator, or colour coding, for different sustainability/ transition/impact metrics. In general, we favour solutions that try to study how investors react to different information.

Our views align with the ESAs in the importance of **consumer testing**.[291] The rationale for transforming the current provisions into actual "labels" is to make it more usable by investors. Thus, the new categories and their implementation should be based on actual consumer tests *ex ante*, to set the categories, and *ex post* to assess whether they are working as intended. Such tests could also extend to the layout of information, especially in digital format. Determining which information is more easily recognisable by investors, and linked with what specific product category, especially if accessed in digital form,[292] is something that can greatly benefit from consumer testing. Needless to say, a more active role in helping build models and methodology to generate the disclosures (supra 6.2.2.), would place the authorities in a privileged position to ensure that the relevant information makes its way to the final investor.

6.4. Mandatory vs. voluntary disclosure regime for adverse "impacts"

The new **SFDR should, in our view, include a mandatory disclosure regime of product-level PAIs** for several reasons. First, **adverse impacts must increasingly be reported by corporates**, under the CSRD. Furthermore, the new mandatory mechanisms to identify adverse impacts, at least the environmental and human rights ones, under the CSDDD, mean that corporates will gradually have systems to identify, assess and prioritise such impacts, which means that they will be less inclined to disguise their lack of curiosity as a lack of "materiality".

Second, if sustainability is a relevant aspect for all financial intermediaries, and the EU framework espouses a "**double materiality**" approach across the whole financial system (and not just among corporates) it seems logical to apply this criterion **in a consistent manner**. Furthermore, if one accepts that the distinction between the "outside-in" and "inside-out" perspectives embodied in double materiality is often not as clear-cut, an adequate reporting of risks may help the authorities in the early detection of risks.

Third, if the SFDR is a "**transformational**" text, there should be an incentive for financial intermediaries to increasingly incorporate "transition" or "sustainability" features into their products. This incentive will exist depending on the **relative cost** for intermediaries of offering a product that considers transition, or sustainability objectives, versus one that does not. If all intermediaries must report PAIs (and not only general information on risks) it will be comparably easier to switch to a category that pursues concrete, measurable sustainability/transition goals.

However, all these considerations must be made with some qualifications. First, **the widespread reporting of PAIs can work if an adequate information infrastructure is in place, and the technological tools are present.** This calls for a relatively proactive approach by the authorities, to help the industry develop best practices, and build the tools.

Second, **flexibility of implementation can incentivise fund managers to stay, and offer products in the EU**, and perhaps adopt the reporting requirements in their general operations. Conversely, suddenly imposing the currently optional requirements as mandatory may have the opposite effect, leaving the EU isolated in global efforts to improve sustainability reporting in the fund industry. Thus,

[291] Ibid paras. 6, 10, and section 2.1, pp. 3, 5, 6,

[292] The ESAs also recommend a requirement to facilitate the provision of information in digital.

reporting of PAIs should follow a phase-in process, where the industry is encouraged to adjust, and build in the necessary capabilities.

Third, authorities should consider **proportionality in calibrating the requirements**. In this sense, the ESAs suggest a sensible approach,[293] where (i) "sustainability" (and, in our view, "impact" products) should report "consideration" of PAIs, i.e., information plus mitigation and time horizons,[294] (ii) other, less ambitious products report only "information" on PAIs, and (iii) the rest of financial products provide minimal disclosures such as "information" about select key PAIs, with a list of priority indicators, plus a disclaimer along the lines of Article 7 TR. There should be a special focus on information that is quantifiable.

The **expansion of the SFDR scope** should be gradual, and, if needed, **experimental**. The uncertainty about the SFDR application to some types of products (e.g., structured products, multi-option products – MOPs[295]) etc. could be bridged if the new rules require the ESAs to choose an approach from a set of options, and subsequently test it to see whether it works, before it is enacted in legislation.

In this spirit, **reforms should also reconsider entity-level disclosures.** Entity-level information should be kept only if it has users. It should be better aligned with product-level information (e.g., on PAIs) and the focus should shift from the current high-level narrative accounts to information that is actionable (and, when possible, quantifiable) by stakeholders or authorities. This may be easier if the authorities themselves are part of the process of development of adequate technological tools, to ensure that access to them is not too costly.

6.5. The risks of over regulation

Mandatory disclosure requirements increase compliance costs. The question is whether the implementation costs imposed on financial market participants by the SFDR framework can be offset by the benefits of the regulation, and whether these costs are only initial compliance costs or whether they would have a lasting impact on the financial services industry.

In the SFDR context the financial sector is not the producer but the user of primary data: "*the dependence on primary data exposes the financial sector to a trade-off between relevance for the investor on the one hand and practical challenges on the other.*"[296] Thus, FMPs need data from information providers, which increases the cost, and makes them dependent on the methodologies for such data.

This problem is difficult to mitigate by an SFDR reform alone. CSRD sustainability reporting is costly for corporates, which have an incentive to underreport adverse impacts (as immaterial) and provide information that is suitable for FMPs or FAs to comply with their reporting of PAIs, or the format and organisation of the information may make it difficult for FMPs and FAs to handle it. This is compounded by the fact that, on product-level disclosure, collecting information and making it available in a way that can be easily understood by the end investor imposes a significant burden in terms of time and cost on FMPs.[297]

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[293] Joint ESAs Opinion on the SFDR para. 56, p. 20.

[294] Supra 4.3.1. See ESAs SFDR Q&A. Section IV PAI Disclosures, Q 3.

[295] Joint ESAs Opinion on the SFDR paras 50-53, p. 19.

[296] EBA, EIOPA, ESMA, Final Report on draft Regulatory Technical Standards on the review of PAI and financial product disclosures in the SFDR Delegated Regulation, 4 December 2023 (JC 2023 55), par. 71.

[297] Commission Summary of responses to Public Consultation and Targeted Consultation, a p. 5: "*when asked about issues surrounding data availability, 98 % (176 out of 180180) of FMPs who responded to these questions said they face difficulties in obtaining goodgood-quality data, and 53% (90 out of 171) reported engaging to a very large or large extent with investee companies to encourage reporting of the missing data.*"

These costs may probably increase if the SFDR framework is amended in light of the ESA's advice on the review of PAIs and disclosure of financial products,[298] and must also be added to the costs imposed by other applicable disclosure regulations, and the difficulties arising from the misalignment and inconsistencies between them.

In the Commission consultation 58% of all respondents do not believe that the costs of disclosure are proportionate to the benefits, and this figure rises to 71% for FMPs and FAs.[299] There is also generalised scepticism around market actors on the SFDR framework's capacity to effectively achieve its specific objectives.[300]

This does not answer the question whether these are initial compliance costs, or a permanent hindrance for the financial sector. However, it makes the case for a careful consideration of the need for a more proactive and constructive role by the authorities in the development of tools and methodologies (from a conceptual and technological perspective) by the industry.

[298] Ibidem. See, for example, the 'cons' in relation to Policy Issue No 3 ("*DNSH disclosure design options*"), option 3.1 ("*maintaining the status quo*"); Policy Issue No 4 ("*GHG emissions reduction targets disclosures*"), option 4.3 ("mandatory GHG emissions reduction targets disclosure"), or Policy Issue No 6 ("*expansion of MOPs provisions*"), option 6.3 ("*new website disclosures, cross referencing periodic disclosures and extensions to options that are not financial products*").

[299] Commission Summary of responses to Public Consultation and Targeted Consultation, a p. 5-6.

[300] Ibidem.

7. CONCLUSIONS AND POLICY RECOMMENDATIONS

Reformers should ask themselves **whether the SFDR purpose is to "cater" to fixed existing investor preferences, a "transformational" text, which seeks to channel funds towards certain activities**, and ultimately effect changes in the real economy, **or a combination of both**. Then, they should think about **who are the SFDR's intended users**. These may be investors, but also other stakeholders, and regulators. **Usability should be the driving principle of reform**.

The **information pipeline**, formed by disclosures by corporates (subject to CSRD and CSDDD), information intermediaries (subject to Benchmarks and ESG Ratings regulation) and FMPs (subject to SFDR) **is not working properly**. The different **legal texts should be better aligned**, and streamlined, prioritising that the information generated by CSRD entities benchmarks and ESG ratings can be directly incorporated into products disclosures. This also **presents a technological challenge**, which requires adequate methodologies and tools. It is advisable that the **authorities take an active role** in ensuring that these tools are easily accessible, to limit over-dependence on third-party data service providers.

Reforms should promote a new system of product categories that is more easily understandable for the end investor, and can simultaneously shift capital flows towards sustainable (or transition) activities. A category of "**transition**" investment products seems essential, and a category that focuses on the "**impact**" of investments too. A category of "**sustainable**" products may be desirable but should probably **sub-divided** by sustainability objectives. They should be accompanied by minimum requirements and thresholds. This may require **a revision of the concept of "sustainable investment" in the SFDR**, which is too broad and uncertain. A **more prescriptive approach seems inevitable**, but should be balanced by adequate **consumer testing** and **market analysis**. Consumer testing should ensure that the **categories** are **precise enough to serve investors' preferences**. Market analysis should ensure that the **categories** are also **broad enough to encompass a sufficiently large share of funds**, which increases the SFDR's transformational effect.

If the SFDR is not only a "catering", but also a "**transformational**" text, **it is advisable** for certain disclosure obligations, e.g., on **PAIs to be applicable to all products**. This may create the incentive to move money away from conventional products, and into some of the new categories. However, **the information to be supplied by regular products should be greatly simplified**. The Commission should also consider what are the **users and purpose, of entity-level information**, keep only the information that has such users and purpose, preferably in a simplified form that is both aligned with product-level information, and actionable.

Finally, the authorities should take into consideration the **costs of the regulation**. As it stands, the SFDR is a remarkable, but costly, piece of legislation. It may be possible to improve disclosures, while also streamlining unnecessary bottlenecks. This reinforces the case for a more active role of the authorities in accompanying the industry in its process to build the methodologies and tools to process data and produce disclosures.

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The Sustainability-Related Financial Disclosures Regulation (SFDR) is the centrepiece of the sustainable finance strategy for funds and other financial products. However, its provisions are too complex, do not work as intended, and interact insufficiently with provisions shaping corporate reporting, indexes, or client preferences. A revised SFRD should include more recognisable product labels or categories, enable and foster transition investments, smoothly interact with corporate reporting, and expand the scope of disclosure obligations.

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